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REFORM OF CORPORATE TAXATION

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

OCTOBER 24, 1983

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CONTENTS

ADMINISTRATION WITNESSES

	Page
Pearlman, Hon. Ronald A., Deputy Assistant Secretary, Tax Policy, Department of the Treasury	9

PUBLIC WITNESSES

Alexander, Donald C., Esq., Morgan, Lewis & Bockius	127
American Bar Association, Edward N. Delaney, chairman, section of taxation, accompanied by John B. Jones, Jr	82
Andrews, William D., Esq., professor of law, Harvard Law School	65
Apache Corp., Raymond Plank, chief executive officer and chairman of the board	322
Bacon, Richard L., Esq., Bell, Boyd & Lloyd	245
Battle, Frank V., Jr., chairman, Federal taxation committee subchapter C project, Chicago Bar Association	114
Berenson, David A., national tax services, Ernst & Whinney	222
Chamber of Commerce of the United States, Edwin S. Cohen, Esq	172
Chicago Bar Association, Frank V. Battle, Jr., chairman, Federal taxation committee subchapter C project	114
Cohen, Edwin, S., Esq., on behalf of the Chamber of Commerce of the United States	172
Delaney, Edward N., chairman, section of taxation, American Bar Association, accompanied by John B. Jones, Jr	82
Ernst & Whinney, David A. Berenson, national tax services	222
Flaherty, Robert T., Flaherty & Crumine, Inc	299
Gallatin, Ronald L., managing director, Lehman Bros. Kuhn Loeb, Inc	286
Georgia Power Co., Warren Jobe, executive vice president	303
Jacobs, Robert A., Esq., Milgrim Thomajan Jacobs & Lee	136
Jobe, Warren, executive vice president, Finance, Georgia Power Co	303
Johnson, Scott W., vice president, Investment Banking Division, Goldman, Sach & Co., on behalf of the Securities Industry Association	316
Lehman Bros. Kuhn Loeb, Inc., Ronald L. Gallatin, managing director	286
Maletta, Thomas P., vice president, taxes, Allegheny International Corp., on behalf of the Tax Executives Institute, Inc	185
McDermott, Robert, Esq., the Timber Realization Co	371
Nad, Leon M., national director, Technical Tax Services, Price Waterhouse	198
New York State Bar Association, Willard B. Taylor, Esq., chairman, taxation section, accompanied by Herbert L. Camp	99
Nolan, John S., Esq., Miller & Chevalier	148
Plank, Raymond, chief executive officer and chairman of the board, Apache Corp	322
Price Waterhouse, Leon M. Nad, national director, Technical Tax Services	198
Roche, James, Esq., McDermott, Will & Emery	263
Sandler, Lewis H., general partner, Southwest Realty, Ltd	362
Securities Industry Association, Scott W. Johnson	316
Slocum, George S., executive vice president and chief financial officer, Transco Energy Co	341
Southwest Realty, Ltd., Lewis H. Sandler, general partner	362
Tax Executives Institute, Inc., Thomas P. Maletta	185
Taylor, Willard B., Esq., chairman, taxation section, New York State Bar Association, accompanied by Herbert L. Camp	99
Timber Realization Co., Robert McDermott, Esq	371

Page
Transco Energy Co., George S. Solcum, executive vice president and chief financial officer 391

ADDITIONAL INFORMATION

Committee press release 1
Opening statement of Senator Dole 1
Prepared statement of Hon. Ronald A. Pearlman 12
Prepared statement of Prof. William D. Andrews 65
Prepared statement of Edward N. Delaney 83
Prepared statement of Willard B. Taylor 100
Prepared statement of Frank V. Battle, Jr 115
Prepared statement of Donald C. Alexander 129
Prepared statement of Robert A. Jacobs 137
Prepared statement of John S. Nolan 150
Prepared statement of Edwin S. Cohen 174
Prepared statement of Thomas P. Maletta 187
Prepared statement of Leon M. Nad 199
Prepared statement of David A. Berenson 223
Prepared statement of Richard L. Bacon and Nicholas Tomasulo 246, 259
Prepared statement of Robert T. Flaherty 301
Prepared statement of Ronald L. Gallatin 288
Prepared statement of James Roche 265
Prepared statement of Warren Jobe 304
Prepared statement of Barrie A. Wigmore 317
Prepared statement of Raymond Plank 324
Prepared statement of George S. Slocum 343
Prepared statement of Lewis H. Sandler 363
Prepared statement of Warren A. Hood 371

COMMUNICATIONS

Arthur Andersen & Co 380
Robert W. Baird & Co., Inc 403
Blyth Eastman Paine Webber 413
Coalition for Low and Moderate Income Housing 428
Chicago Bar Association 418
Dean Witter Reynolds Inc 435
Deloitte Haskins & Sells 455
Dorchester Hugoton, Ltd 466
E. F. Hutton & Co., Inc 469
Employee Stock Ownership Association 482
First Boston Corp 484
Florida Power & Light Co 496
General Motors Corp 498
May Energy Partners Ltd., and Snyder Oil Partners 501
McCormick Oil & Gas Co 527
Morgan Stanley & Co., Inc 547
MGIC Investment Corp 554
Muge Rose Guthrie Alexander & Ferdon 561
National Association of Independent Insurers 567
National Investment Services of America, Inc 570
National Realty Committee 571
Newhall Investment Properties and Newhall Resources 577
Petroleum Investments, Ltd 587
Share the Work Coalition 589
Sherman & Howard 593
Simpson, Fair & Rinaldo 599

REFORM OF CORPORATE TAXATION

MONDAY, OCTOBER 24, 1983

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 2:35 p.m., in room SD-215, Dirksen Senate Office Building, Hon. Robert J. Dole (chairman) presiding.

Present: Senators Dole and Danforth.

[The press release announcing the hearing and the opening statement of Senator Dole follow:]

[Press release]

FINANCE COMMITTEE SETS HEARING ON REPORT ON REFORM OF CORPORATE TAXATION

Senator Robert J. Dole (R., Kans.), Chairman of the Committee on Finance, announced today that a hearing will be held on Monday, October 24, 1983 on the reform and simplification of the corporate income tax.

The hearing will begin at 10:00 a.m. in Room SD-215 of the Dirksen Senate Office Building.

The hearing will examine the recent Finance Committee staff report and recommendations on the reform and simplification of corporate and shareholder income taxation.

"The staff report is the result of 11 months of careful study," Senator Dole noted. "The report identifies not only a number of loopholes in the current law, but also a number of cases in which unintended hardships arise. That is hardly surprising because the Congress has not carefully examined the corporate tax for 50 years. The report itself reflects the work of the American Law Institute, the American Bar Association Tax Section, and an informal working group of tax practitioners who assisted the staff in this project."

Senator Dole particularly asked witnesses to comment on the following questions:

(1) If gain is taxed to the corporation on the distribution of appreciated property, is any relief appropriate either on a temporary or permanent basis? If relief is considered necessary, how should it be structured?

(2) Does the 85 percent dividends received deduction, when coupled with the full deductibility of short-term capital losses, constitute a loophole or present unintended benefits?

(3) If, as the staff suggests, the limitation on dividend treatment of distributions by corporations provides opportunity for abuse, should the earnings and profits limitation be repealed, or should a narrow set of revisions to the rules be attempted?

(4) What special limitations on net operating losses and other tax attributes are desirable in acquisitions?

(5) Should inactive limited partnerships with publicly traded partnership interests be taxed as corporations?

STATEMENT OF SENATOR BOB DOLE, REFORM AND SIMPLIFICATION OF CORPORATE TAXATION, OCTOBER 24, 1983

For the first time in fifty years, this afternoon's hearing will give the Congress a careful, comprehensive look at the fundamental rules for corporate taxation. The staff has identified a number of serious problems, and has proposed a number of possible simplifying solutions. These proposals are a result of the same effort to simplify and reform the federal income tax that yielded the subchapter S and installment sales bills in the 96th and 97th Congresses. Before turning to the substance of this afternoon's hearing, I want to comment briefly on the process that has led to this hearing, and the steps that remain before us.

Almost one year ago I issued a press release calling first for public comments on corporate tax reform and then a staff study. Although we obviously made a great deal of progress in 1982 eliminating corporate tax loopholes, preliminary study suggested that more could and should be done. That press release singled out recent proposals by the American Law Institute and the American Bar Association tax section as meriting study.

We received a number of public comments as well as more informal comments. We have studied those comments and the ABA and ALI proposals very carefully. Indeed these questions have probably already had the most careful consideration over the past year of any issues now pending before the Congress.

The staff concluded that it could do a better job of evaluating the prior legislative proposals and making recommendations to the Congress if it solicited the assistance of a number of distinguished tax practitioners. The working group that resulted has, thus far, met ten times over the past six months and there will be further meetings next month. I want to take this occasion to thank the members of the working group publicly for their dedicated volunteer service:

M. Bernard Aidinoff, former chairman of the ABA Tax Section and a distinguished private practitioner in New York City.

Donald Alexander, former Commissioner of the Internal Revenue Service, and a distinguished private practitioner in Washington, D.C. Don Alexander will appear this afternoon in his individual capacity.

William D. Andrews, professor of law, Harvard University and reporter for the American Law Institute on its corporate taxation proposals. Bill Andrews will appear this afternoon in his individual capacity.

Frank Battle, Jr., a distinguished private practitioner in Chicago, Illinois. Frank Battle will appear on behalf of the Chicago Bar.

Herbert Camp, chairman of the New York State Bar Association Tax Section Committee on Corporations.

Peter Faber, former chairman of the ABA Tax Section's Committee on Corporate Stockholder relations and a private practitioner in New York.

Martin D. Ginsburg, professor of law at Georgetown University and former chairman of the New York State bar association tax section.

Fred T. Goldberg, former assistant to the Commissioner of Internal Revenue, now a private practitioner in Washington, D.C.

Harold Handler, chairman of the association of the bar of the city of New York's Tax Section.

James Holden, a distinguished practitioner in Washington, D.C.

Robert Jacobs, chairman of the ABA Tax Section's Committee on Corporate stockholder relations and a practitioner in New York City.

Howard Krane, a distinguished practitioner in Chicago, Illinois.

Willard Taylor, chairman of the New York State Bar Association Tax Section, and a private practitioner in New York.

This Committee may never before have had the benefit of so much hard work by such as distinguished group. Indeed it is hard to imagine a more distinguished group of corporate tax lawyers. The hard work of this group is reflected in the staff report. That is not to say that any or all of these individuals support any particular proposal made by the staff. In this project we have also benefited from the technical assistance of the experts at the Internal Revenue Service and the Treasury Department.

In undertaking this project the staff made five very sensible assumptions. First, it was assumed that we would continue, in general, to have a corporate level tax. That is, we would neither abolish the corporate level tax nor tax shareholders on all corporate income without regard to its distribution. Many of us—including the President, apparently—have substantial doubts about the ultimate desirability of imposing a corporate level tax. But it is pretty clear to this Senator that politics and economics will prevent any radical change in the near future.

Second, the report assumes that the tax law will continue generally to distinguish between ordinary income and capital gains, and that dividends will be taxed as ordinary income. In general, that premise is uncontroversial, although one witness will argue that dividends should generally be treated as returns of capital.

Third, it was assumed that we should permit corporations to merge tax-free in a variety of circumstances. That will permit investments to be shifted into the most productive enterprises.

Fourth, it was assumed that individuals would be permitted a step-up in basis for assets held at death.

Fifth, the staff addressed this project as a means of preventing abuses, closing loopholes, simplifying the rules and eliminating unintended hardships. The staff has not been instructed to come up with a revenue-raising proposal.

It is clear that some of the witnesses misunderstood what the staff was instructed to do. One witness characterizes the "preoccupation" of the report with abuse and manipulation as "disturbing." This Senator is more disturbed by the manifold types of abuse and manipulation—a few of which I will highlight below—than by the report. Let's not shoot the messenger.

I want to thank all of the members of the working group, and particularly those appearing today, for their efforts.

Leveraged buy-outs. Last week the Wall Street Journal ran a story that described a problem identified by the staff report. Because liquidation of a corporation or a deemed liquidation following an acquisition of a controlling stock interest in a corporation permits the step-up in basis for acquired assetts without payment of a corporate level tax, the Federal income tax provides an unintended bias in favor of the sale of businesses.

Corporate acquisitions. The staff report noted that the current law provides an unintended benefit for corporations who buy substantial amounts of a target corporation's stock and pay for them with borrowed money. This possibility has been vividly demonstrated by the recent investment by Mesa Petroleum in Gulf Oil.

In rough terms, according to Mesa's filing with the SEC, its investment group has acquired $630 million worth of Gulf Oil Corporation stock, which pays a $3 dividend per share. Approximately $500 million or more of the stock was paid for with borrowed money that accrues interest at about 11 percent. As a result, Mesa Petroleum, in the first quarter, will have a cash flow, economic loss of about $2.875 million on its investment. The tax law will convert this pre-tax loss into an after-tax gain of $2.575 million.

Whatever we think of the Mesa Petroleum investment in Gulf, many of us probably think that the tax law should be neutral—and should not provide a tax subsidy for such investments—particularly when we have an estimated nearly $200 billion federal deficit.

Publicly traded companies. There is currently listed on the New York Stock Exchange, a company with about $1 billion in assets and 5 to 10 thousand equity owners. It paid no tax last year and will pay no tax next year. Under current law, it is exempt from federal income tax. For State law purposes, this entity is a limited partnership. Should such entities be exempt from tax if they are formed in the future?

Dividend rolls. Another problem identified by the staff report that has received substantial attention is the dividend roll. Currently, corporations may obtain substantial tax benefits by buying preferred stock shortly before a dividend declaration, then selling such stock immediately after the declaration of the dividend. The corporation is entitled to the dividends received deduction—reducing the tax rate on the dividend to a maximum of 6.9 percent. The corresponding short-term capital loss, however, offsets tax at up to a 46 percent rate. The resulting 39.1 percent tax rate arbitrage presents an enormous loophole.

For example, when the Chrysler Corporation pays a $110 million cumulative dividend next week, the loss to the Treasury probably be at least $43 million—and may be even more if certain other tax avoidance techniques are employed.

The staff report makes comprehensive recommendations in six areas:

(1) Mergers, acquisitions and liquidations;
(2) Special limitations on net operating losses;
(3) Corporate distributions;
(4) Basis in controlled subsidiaries;
(5) Classification of entities as corporations; and
(6) Use of foreign corporations to avoid tax.

I do not want to recapitulate here each of the proposals described in the report. The announcement of this hearing asked five principal questions relating to those proposals. I am pleased by the careful attention that the witnesses have given to these problems and questions.

There are, however, two substantive problems on which I want to comment further.

First, more than any other staff proposal, the suggestion that publicly traded limited partnerships formed in the future should be taxed as corporations has excited a great deal of interest. Three comments are in order.

First, if the committee were to adopt this proposal, this Senator would seek to apply the rule only prospectively. At this time, I see no reason to apply the new rules to existing entities. Moreover, I agree with those witnesses who suggest that we ought to look at this problem very carefully before acting. Finally, there is no hidden agenda. There is no plan to extend these rules to other publicly marketed limited partnerships or partnerships with more than a certain number of partners.

Second, a number of witnesses spend a lot of their time explaining that publicly traded limited partnerships are generally treated as partnerships under current law. That question is not at issue. What we are here this afternoon to wrestle with is not whether such entities are treated as partnerships, but whether such entities should be treated as partnerships.

Third, I hope that the witnesses will focus on the problem stated at the outset: Should a billion dollar New York Stock Exchange Company with ten thousand shareholders be exempt from tax? Should, General Motors be given an election to pay tax as a corporation or to distribute all of its assets to GM Limited Partnership and thereafter pay no tax?

The second area that merits special comment is the proposal to limit the dividends received deduction. There seems to be little doubt that the dividend roll and short-sale problems described by the report pose serious problems. More serious problems are posed, however, by the use of the dividends received deduction to finance corporate acquisitions and the issuance of preferred stock by non-taxpaying corporations as a means to transfer tax deductions that cannot be used. Issuance of preferred stock by such non-taxpayers poses to some the same problems as safe harbor leasing or trafficking in net operating losses.

Nevertheless, many of the witnesses suggest that the report's proposals would adversely affect capital markets and have unintended results. Once we agree on what the problems are, perhaps we can come up with narrower solutions.

At least one commentator has characterized this project as embryonic. After 12 months of staff study and public discussion, preceded by a decade of professional discussion, if this project were embryonic, it would imply a longer gestation period for tax legislation than I have recently seen.

This Senator does not regard this project as an academic exercise. The Washington Post put it very well in endorsing these proposals nearly a month ago: "There will be many voices urging more years of study, but the time for action is now."

Based upon the testimony we will receive at this hearing—most of which was submitted in advance and has been studied by me and by the staff—it is my hope to move forward with this project on a bipartisan basis. At the least, I hope that Senator Long and I will get a bill introduced by December. It may even be possible to bring this matter before the finance committee, if the Senate does not recess on schedule. With respect to the proposed changes to the dividends received deduction of course, those changes are already pending before the committee.

The CHAIRMAN. Let me first apologize to the witnesses and others who have been inconvenienced, but we have been having a briefing on the situation in Lebanon with Secretary Shultz, and I'm certain you will understand the importance of that. So we will proceed with the hearing.

I think other members who may wish to attend the hearing will be here shortly after the briefing concludes, about 3.

I would like to take 2 or 3 minutes to highlight a statement that I will ask be made a part of the record, concerning the purpose of these hearings and where we intend to go as we move along. Then we will move quickly into the witness list and try to accommodate as many as we can.

For the first time in 50 years, this afternoon's hearing will give the Congress a careful, comprehensive look at the fundamental rules for corporate taxation. The staff has identified a number of serious problems and has proposed a number of possible simplifying solutions. These proposals are a result of the same effort to simplify and reform the Federal income tax that yielded the subchapter S and installment sales bills in the 96th and 97th Congresses.

Before turning to the substance of this afternoon's hearing, I want to comment briefly on the process that led to this hearing and the steps that remain before us.

Almost 1 year ago I issued a press release calling first for public comments on corporate tax reform and then a staff study. Although we obviously made a great deal of progress in 1982 under Senator Danforth's and Congressman Stark's leadership in eliminating corporate tax loopholes, preliminary studies suggested that more could and should be done. That press release singled out recent proposals by the American Law Statute and the American Bar Association tax section as meriting study.

We received a number of public comments as well as more informal comments, and we have studied those comments and the ABA and ALI proposals very carefully. Indeed, these questions have probably already had the most careful consideration over the past year of any issues now pending before the Congress.

The staff concluded that it could do a better job of evaluating the prior legislative proposals and making recommendations to the Congress if it solicited the assistance of a number of distinguished tax practitioners. The working group that resulted has, thus far, met 10 times over the past 6 months, and there will be further meetings next month. I want to take this occasion to thank the members of the working group publicly for their dedicated volunteer service. They are well-known by many in the tax field:

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Donald Alexander, former Commissioner of the Internal Revenue Service, and a distinguished private practitioner in Washington—he will be appearing later;

William D. Andrews, professor of law, Harvard University, and reporter for the American Law Institute on its corporate taxation proposals; and he will be appearing later;

Frank Battle, Jr., a distinguished private practitioner in Chicago, Ill.—and he will be appearing;

Herbert Camp, chairman of the New York State Bar Association tax section committee on corporations;

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Harold Handler, chairman of the association of the bar of the city of New York's tax section;

James Holden, a distinguished practitioner in Washington, D.C.;

Robert Jacobs, chairman of the ABA's tax section's committee on corporate stockholder relations, and a practitioner in New York;

Howard Krane, a distinguished practitioner in Chicago, Ill.; and

Willard Taylor, chairman of the New York State Bar Association tax section, and a private practitioner there.

I don't recall this committee ever having the benefit of such a more distinguished group. It is hard to imagine a more distinguished group of corporate tax lawyers, and I think the work of this outstanding group has been reflected in the staff report.

In undertaking this project the staff made five very sensible assumptions. First, it was assumed that we would continue, in general, to have a corporate level tax. That is, we would neither abolish the corporate level tax nor tax shareholders on all corporate income without regard to its distribution. Many of us—including the President, apparently—have substantial doubts about the ultimate desirability of imposing a corporate level tax. But it is pretty clear to this Senator that politics and economics will prevent any radical change in the near future.

Second, the report assumes that the tax law will continue generally to distinguish between ordinary income and capital gains, and that dividends will be taxed as ordinary income. In general, that premise is uncontroversial, although one witness will argue that dividends should generally be treated as returns of capital.

Third, it was assumed that we should permit corporations to merge tax free in a variety of circumstances. That will permit investments to be shifted into the most productive enterprises.

Fourth, it was assumed that individuals would be permitted a step up in basis for assets held at death.

And fifth, the staff addressed this project as a means of preventing abuses, closing loopholes, simplifying the rules, and eliminating unintended hardships. The staff has not been instructed to come up with a revenue-raising proposal, contrary to some reports that I have seen.

It is clear that some of the witnesses misunderstood what the staff was instructed to do. One witness characterizes the "preoccupation" of the report with abuse and manipulation as "disturbing." This Senator is more disturbed by the manifold types of abuse and manipulation—a few of which I will highlight below—than by the report. I would just suggest we shouldn't shoot the messenger until we have found out what the message is.

I want to thank all of the members of the working group and particularly those appearing today.

Let me just touch on a few of the areas that many in the audience probably understand better than this Senator, but they are areas that we believe need some concern. We are busy looking at the food stamp program and the WIC program and all these programs that affect low-income Americans, to try to find abuse and fraud and where they can be tightened up, and I believe we have the same level of responsibility, if not a greater responsibility, to tighten up the loopholes where we find them in the Tax Code. So it is not with any hesitation that we proceed with this hearing, and I think we will have an agreement from responsible people in the industry and I think generally can work out any problems we may have.

Leveraged buyouts is one area that we are trying to identify and we have identified. If you read last week's Wall Street Journal you saw the story that described a problem identified by the staff report. Because liquidation of a corporation or a deemed liquidation following an acquisition of a controlling stock interest in a corporation permits the stepup in basis for required assets without payment of a corporate level tax, the Federal income tax provides an unintended bias in favor of the sale of businesses.

Another area is corporate acquisitions. The staff report noted that the current law provides an unintended benefit for corporations who buy substantial amounts of a target corporation's stock and pay for them with borrowed money. This possibility has been vividly demonstrated by the recent investment by Mesa Petroleum in Gulf Oil.

In rough terms, according to Mesa's filing with the SEC, its investment group has acquired 630 million dollars' worth of Gulf Oil Corp. stock, which pays a $3 dividend per share. Approximately $500 million or more of the stock is paid for with borrowed money that accrues interest at about 11 percent. As a result, Mesa Petroleum, in the first quarter, will have a cash flow economic loss of over $2 million on its investment. The tax law will convert this pretax loss into an after-tax gain of $2 million.

Whatever we think of the Mesa Petroleum investment in Gulf, many of us probably think that the tax law should be neutral and should not provide a tax subsidy for such investments, particularly when we have an estimated nearly $200 billion Federal deficit this year and for the next several years.

Another area for scrutinizing is publicly traded companies. There is currently listed on the New York Stock Exchange a company with about $1 billion in assets and 5,000 to 10,000 equity owners. It paid no tax last year and will pay no tax next year. Under current law it is exempt from Federal income tax. For State law purposes, this entity is a limited partnership. Should such entities be exempt from tax if they are formed in the future?

Another problem identified by the staff report that has received substantial attention is the dividend roll. Currently, corporations may obtain substantial tax benefits by buying preferred stock shortly before a dividend declaration, then selling such stock immediately after the declaration of the dividend. The corporation is entitled to the dividends-received deduction, reducing the tax rate on the dividend to a maximum of 6.9 percent. The corresponding short-term capital loss, however, offsets tax at up to a 46 percent rate. The resulting 39.1 percent tax rate arbitrage presents an enormous loophole.

For example, when the Chrysler Corp. pays a $110 million cumulative dividend next week, the loss to the Treasury will probably be at least $43 million—and may be even more if certain other tax avoidance techniques are employed.

I would just suggest that we have tried to be specific, we are not on any fishing expedition. There are some areas that ought to be addressed. The staff report makes recommendations in six areas—mergers, acquisitions and liquidations; special limitations on net operating losses; corporate distributions; basis in controlled subsidiaries; classification of entities are corporations; and finally, the use of foreign corporations to avoid tax. And we will go over those as we get into the year.

I would just say, finally, with reference to publicly traded partnerships, more than any other staff proposal, the suggestion that publicly traded limited partnerships formed in the future should be taxed as corporations has excited a great deal of interest. And I would just make three comments that would sort of focus on that:

First, if the committee were to adopt this proposal, this Senator woull seek to apply the rule only prospectively. At this time, I see no reason to apply the new rules to existing entities. Moreover, I agree with those witnesses who suggest that we ought to look at this problem very carefully before acting. Finally, there is no hidden agenda. There is no plan to extend these rules to other publicly-marketed, limited partnerships or partnerships with more than a certain number of partners. Second, a number of the witnesses spent a lot of their time explaining that publicly traded, limited partnerships are generally treated as partnerships under current law. That question is not at issue. What we are here this afternoon to wrestle with is not whether such entities are treated as partnerships, but whether such entities should be treated as partnerships.

Third, I hope that the witnesses will focus on the problem stated at the outset: Should a billion dollar New York Stock Exchange company with 10,000 shareholders be exempt from tax? Should General Motors be given an election to pay tax as a corporation or to distribute all of its assets to GM limited partnership and thereafter pay no tax?

One other area is the proposal to limit the dividends-received deduction. There seems to be little doubt that the dividend-roll and short-sale problems described in the report holds serious problems. More serious problems are posed, however, by the use of the dividends-received deduction to finance corporate acquisitions and the issuance of preferred stock by nontaxpaying corporations as a means to transfer tax deductions that cannot be used. Issuance of preferred stock by such nontaxpayers poses to some the same problems as safe-harbor leasing or trafficking in net operating losses.

Now, we may have some witnesses who may not agree with that, but we can perhaps look for narrower solutions.

So I just suggest that this is the first hearing. We have had 12 months. Somebody characterized this report as embryonic. We do a lot of things around the Congress that may be embryonic, but it's not in this particular area. We have had about 12 months of study and public discussion, preceded by a decade of professional discussion; if this project were embryonic, it would imply a longer gestation period for tax legislation than we have seen recently and that we may see in the next few days.

This Senator does not regard this project as an academic exercise. I don't normally quote from the Washington Post or any other paper, but they indicated there will be many voices urging more years of study, but the time for action is now.

So, it is my hope that we can work out a bill, introduce it as we have done in the past on bipartisan basis. We are looking at some of the most glaring loopholes now, to try to put them in our package, which you will have a chance to see later on this week.

Having frightened everybody with that last statement, we will now move to the witnesses.

Mr. Ronald A. Pearlman, Deputy Assistant Secretary for Tax Policy, Department of the Treasury.

STATEMENT OF RONALD A. PEARLMAN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Mr. PEARLMAN. Thank you, Mr. Chairman.

I appreciate being here today. I am going to, about as summarily as I can, report to you on the Treasury's views on the staff proposal. We have submitted a statement for the record, and the details are in the statement.

Let me say, at the outset, that we are in strong support of the goals of the staff's proposals. We want to compliment the chairman on his leadership in directing the staff study, and commend the staff on the considerable efforts expended over the past year, the manner in which these complex matters have been explored, and the quality of the end product.

The scope of these proposals is enormous. They will affect to some extent, every corporation and every shareholder. With proposals this broad, it is understandable that not everyone is going to agree with every proposal; and indeed, we do not agree with every proposal. However, we hope our disagreements will not be viewed as opposition to the project or to the proposals' goals. We hope to evidence our support by our commitment to work with the committee and with the staff in seeking to achieve these goals.

I am going to go over each of the major proposals that you mentioned in your opening statement, Mr. Chairman, and simply indicate Treasury's views on those proposals, as briefly as possible.

We are supportive of the acquisition proposals primarily because they will bring consistency and symmetry to corporate transactions, which we do not believe is present in current law, and will minimize the significance of form rather than maximize that significance as is present in current law.

We think it is a bit dangerous, however, to sell these proposals as simplification. Corporate transactions by their nature are complex, and they will continue to remain complex, we suspect. We would guess that, ultimately, the rules governing those transactions will be complex; but, in our judgment, that does not mean that the proposals do not deserve support.

In connection with the acquisition proposals, we are supportive of the proposals to provide elective, gain recognition, or tax-free treatment at the corporate level, recognizing that the consequence to the acquiring coporation will flow consistently from which election is made.

We likewise believe that at the shareholder level taxation should be based, not on the corporate tax treatment, but on the consideration received by the shareholder in the transaction.

We want to emphasize that our support for corporate level electivity is appropriate only to the extent that the corporation whose assets are sold or whose stock is purchased, the so-called target corporation, is required to recognize gain or loss if a taxable election is made. We could not support basis step-up by the acquiring corporation without a corresponding gain or loss recognition.

Thus, the so-called General Utilities doctrine, discussed in some detail in the report and in our statement, in our judgment would have to be repealed in order for the corporate electivity to be applicable.

We believe that the repeal of General Utilities will improve the approach to taxing corporate acquisitions. However, we also believe that, because the repeal of General Utilities will result in two levels of tax—one based on the target corporation's gain and one based on the shareholder level gain—it is appropriate to avoid that double taxation in certain circumstances, and that relief from double taxation should be granted if the proposals go forward.

We have suggested in our statement, Mr. Chairman, that that relief comes in the form of a shareholder credit. We recognize that the credit concept is complex and has other drawbacks. Nevertheless, this is an approach that we would like to explore with the committee in an effort to provide appropriate relief.

Under the liquidation proposals of the report, inkind distribution of assets would also trigger a corporate-level tax as the result of the repeal of General Utilities, and would result in a consequent shareholder tax because of the distribution. We believe that a double tax on an inkind distribution of assets by a corporation—particularly if made to historic shareholders and if the distribution is of an ongoing business—is inappropriate, and that some relief is in order. We suggest that it would be appropriate to provide that relief in the form of a carryover basis to the shareholders, perhaps with some gain being recognized as the result of accumulated undistributed earnings, and perhaps with the possibility that a condition of that carryover basis would be that there would be no step up in the basis of the assets on a shareholder's death.

We support the application of the repeal of General Utilities in connection with distribution of property, either as dividend distributions or in redemption transactions.

In connection with the earnings and profits proposal of the report, we are concerned by the proposal that the earnings and profits limitation be repealed. We think that the problems the staff raises in connection with the earnings and profits concept are best dealt with by identifying the issues and trying to deal with them on an item-by-item basis.

With respect to the 85-percent corporate dividends received deduction, two proposals are made by the staff: One would involve the lengthening of the holding period that would be applicable prior to the time the dividends-received deduction would be available. We are supportive of, and sympathetic to, a suggestion that the holding period be extended. We are not sure that the 1-year holding period that is suggested in the report is the appropriate one, but we believe some extension is appropriate.

We have suggested in our statement that, if the holding period requirement is not met, instead of disallowing the corporate dividends received deduction, another approach to dealing with the problem is possible—namely, to make a cost-basis allocation between the stock purchased and the dividend right that the purchaser acquires. We think that produces a better result than simply disallowing the dividends-received deduction.

In connection with leveraged corporate stock acquisitions, we share the staff's concern, but we oppose the proposal to disallow the corporation's interest deduction under a mechanical rule which matches the first dollar of dividend income with the first dollar of interest expense. In cases where we are able to match deductible interest payments with dividend income, we think the proposal has conceptual merit. But a mechanical disallowance rule does not, in our opinion, match actual income and expense, and ignores whether the total distributions made by the recipient corporation are, to a material degree, in the form of interest or dividends.

With respect to the recommendations relating to the taxation of foreign corporations, we are generally supportive of the proposals described in the report. We have some concern about the breadth of these proposals generally as applied to foreign corporations and suggest that some additional study be given to the foreign implications.

With respect to the provisions relating to the carryover of net operating losses and other tax attributes, let me say that we are quite supportive of the proposal contained in the report. In our statement we have indicated that we think the rules could be simplified, by applying a single rather than two rules to purchase and the tax-free reorganization transactions; we think that single rule should be the so-called purchase rule described in the statement.

Here, Mr. Chairman, since the net operating loss rules of the 1776 act come into effect beginning January 1, 1984, it is possible that there may be some need to delay that effective date in order to give the Congress the opportunity to implement the appropriate operating loss rules. Certainly this is one area of the report that does need rather prompt attention.

Finally, we comment briefly on the staff's proposal to classify as associations taxable as corporation limited partnerships whose interests are traded. We oppose this proposal.

Our principal objection is that classification of business organizations involves matters, policy considerations, and tax details that, in our judgment, go well beyond the scope of this project.

Questions such as how a type of organization should be taxed, whether a so-called C-corporation, an S-corporation or as a partnership or, for that matter, as a real estate investment trust or a regulated investment company, require, we believe, an analysis of all of those classification situations. We suspect that if that analysis were undertaken, we would not agree to base tax classification on the degree of marketability of an organization's equity interests.

Mr. Chairman, that concludes my prepared remarks. I would like to thank you again for giving us the opportunity to express our comments, and again to commend the staff on its fine work.

We look forward to working with you and the members of the committee and the staff as your project goes forward.

Thank you.

[The prepared statement of Hon. Ronald A. Pearlman follows:]

For Release Upon Delivery
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STATEMENT OF
RONALD A. PEARLMAN
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to present the views of the Treasury Department on a preliminary report, prepared by the Staff of this Committee (the "Staff"), entitled "The Reform and Simplification of the Income Taxation of Corporations." This report sets forth proposals which would make fundamental changes to many of the rules of Subchapter C of the Internal Revenue Code (the "Code") governing the taxation of corporations and their shareholders. Three principal suggestions are advanced: (1) A new scheme for taxing corporations and shareholders participating in corporate mergers, acquisitions or liquidations would be provided; (2) The taxation of distributions by ongoing corporations to their shareholders would be changed significantly; and (3) A new set of rules would be created to determine the extent to which net operating losses and other corporate tax attributes survive corporate acquisitions. The report also addresses other collateral matters including the classification of publicly traded limited partnerships as corporations for tax purposes, and certain issues arising in connection with the taxation of foreign corporations.

The stated goals of the proposals are four fold: (1) To simplify the taxation of corporate transactions; (2) To prevent corporations from obtaining unintended tax benefits; (3) To make the tax law more neutral with respect to the structuring of corporate transactions; and (4) To improve compliance with the tax laws.

I will summarize briefly our position on the respective proposals before discussing each in more detail:

1. Acquisitions. The Treasury Department supports granting the corporate parties to an acquisition an explicit election to treat the transaction as either taxable or tax-free. We also agree with the proposal to require corporate level recognition of gain or loss on the assets acquired whenever the acquisition is effected with a taxable election and those assets take a stepped-up basis in the hands of the acquiring corporation. However, we do not believe that the acquisition should result in double taxation of liquidating gains, and suggest that relief in the form of a shareholder tax credit be explored.

We also support treating the tax consequences of an acquisition at the shareholder level independently of the consequences at the corporate level. Further, we agree that, to the extent a shareholder receives qualifying consideration, the shareholder should be entitled to nonrecognition of gain or loss without regard to the consideration received by, or the tax consequences resulting to, other shareholders.

2. Liquidations. The Treasury Department agrees that, in general, liquidations of nonsubsidiary corporations should be treated analogously to taxable corporate acquisitions. We also believe, however, that serious consideration should be given to allowing an in kind liquidation to be accomplished on a wholly or partially tax-free basis under appropriate circumstances.

3. Distributions. The Treasury Department supports the proposal which provides that a corporation recognizes gain on a dividend distribution of appreciated property to noncorporate shareholders. We oppose, however, eliminating the earnings and profits limitation on dividend income. To the extent inadequacies in the rules presently exist, we prefer identifying and rectifying the specific sources of the problems.

The Treasury Department agrees that the holding period for stock on which dividends would be eligible for the dividends received deduction should be increased to provide a market risk sufficient to offset the arbitrage possibilities presented. When the holding period is not satisfied, we suggest that the arbitrage possibilities be eliminated through an adjustment to the basis of the stock. We oppose, however, the proposed amendment to section 265 to disallow interest deductions on debt incurred to purchase or carry certain corporate stock. Rather, we believe that the appropriate solution lies in a reappraisal of the dividends received deduction provisions themselves.

4. Foreign Rules. The Treasury Department believes that the impact of the proposals generally on the taxation of foreign corporations and their shareholders requires further analysis. With respect to the report's specific foreign recommendations, the Treasury Department agrees that the tax avoidance purpose test of section 367(a) should be amended to require an appropriate "toll charge" as a condition for certain tax-free transfers to a foreign corporation. We believe that the report's proposals relating to the timing and extent of "recapture" of untaxed earnings (and certain unrealized gains) of a controlled foreign corporation require further study.

5. Special Limitations on Net Operating Losses and Other Tax Attributes. The Treasury Department generally supports limiting the use of net operating loss carryovers after an acquisition by reference to the income attributable to the pool of capital that generated the loss. We believe, however, that the technical provisions proposed by the Staff to implement this approach might be simplified and improved by adoption of a single rule applicable to all acquisitions.

6. Entity Classification. The Treasury Department opposes the proposal which treats limited partnerships with publicly traded partnership interests (or instruments evidencing interests in partnership interests) as associations for tax purposes.

In general, the Treasury Department strongly supports the overall goals of the proposal, and we commend the Staff's efforts to identify those corporate tax provisions of current law which need to be revised. At the outset, however, we wish to emphasize that the scope of these proposals is enormous. They would make fundamental changes to the rules that govern the most basic, as well as the most intricate, corporate transactions, some of which have been in the law since 1918. The proposals would affect, to some degree, every corporation and every shareholder. Accordingly, we strongly believe that adoption of these proposals should come only after they have been translated into specific statutory provisions and subjected to deliberate and detailed technical and policy analyses by all interested parties. We would be pleased to work with the members of the Committee and the Staff on an ongoing basis to develop such a legislative package.

A special consideration applies, however, with respect to the rules regarding the limitations on net operating loss carryovers, since the provisions enacted in 1976 are presently scheduled to become effective in 1984. Accordingly, more rapid development of that portion of the proposals is required. By the same token, however, enactment of these provisions should not be undertaken without adequate time for detailed study. Therefore, we suggest that the effective date of the 1976 revisions be deferred for a few months so that the Congress is not faced with the choice of enacting incompletely developed proposals or allowing the former, undesired provisions to come into effect.

Additionally, while we support the goals of the proposals, it must be pointed out that certain of the proposals cannot be expected to achieve each of their stated objectives. For example, many of the transactions to which the acquisition proposals will apply are extremely complex and intricate. Any new scheme for taxing those transactions will necessarily mirror that complexity. Thus, we do not believe that those proposals should be viewed as an effort to simplify the tax laws. With appropriate modifications, however, the proposals may be justified on the grounds that they will make the taxation of corporate acquisitions more rational, and will make the tax laws less important with respect to the structuring of those transactions.

Similarly, not all of the transactions affected by these proposals are susceptible of taxpayer abuse. To the extent that specific abuses have been identified which mandate a prompt legislative solution, we would be pleased to assist in that effort. We believe, however, that some of the perceived abuses identified in the report can be addressed in ways that do not require implementation of the Staff's proposals.

It also should be noted that the proposals are not only far-reaching, but several would have significant revenue consequences. I wish to reaffirm that the Administration opposes any legislation at this time which would increase taxes. Accordingly, our support for certain of the proposals is based on our determination that they will prevent taxpayers from claiming unintended tax benefits. Our support for other proposals is based upon our understanding that they would not have any significant revenue impact.

Finally, we wish to call attention to one of the most basic assumptions upon which this report rests. The report assumes that the present system of imposing a corporate level tax on corporate profits and a separate tax on shareholder gains and dividends will continue indefinitely. The strength of many of the proposals lies in their rationalizing and strengthening this two-tier tax to the greatest extent possible. We believe, however, that Congress should not embark upon such a fundamental strengthening of this two-tier tax system without at least giving serious consideration to whether integration of the corporate and shareholder taxes is a more desirable long-term objective.

I will turn now to a discussion of the specific Staff proposals.

The Acquisition Proposals

Description

The acquisition proposals would revise the tax consequences to parties participating in corporate acquisitions. The proposals have three essential elements:

1. The corporate parties may elect to have the transaction treated as either a tax-free or taxable acquisition. If taxable treatment is elected, the acquiring corporation ("Acquiring") inherits none of the tax history of the acquired corporation ("Target"), and Acquiring takes a stepped-up basis for the assets acquired (i.e., the tax basis of the assets at the time of the acquisition reflects the value of the consideration paid by Acquiring). If tax-free treatment is elected, all of Target's historic tax attributes, including asset basis, remain intact.

2. In any transaction in which taxable treatment is elected, Target must recognize all gains and losses which inhere in its assets, with certain limited exceptions described below. This result would reverse present law, which provides that a corporation generally does not recognize gain or loss on the distribution of property to shareholders or on sales of property incident to complete liquidations. If tax-free treatment is elected, Target generally would not recognize any gain or loss as a result of the acquisition.

3. The tax consequences to Target's shareholders is determined independently of the tax treatment elected by the Target corporation. If qualifying consideration -- generally stock of Acquiring -- is received by a Target shareholder, no gain or loss is recognized on the exchange of Target stock, and

the basis of the Target stock surrendered is substituted as the basis for the Acquiring stock received. If nonqualifying consideration -- generally cash or notes of Acquiring -- is received, gain is recognized on the Target stock exchanged to the extent of the nonqualifying consideration. Further, if receipt of nonqualifying consideration is equivalent to the receipt of a dividend, the value of the nonqualifying consideration is taxed as dividend income without regard to the amount of gain realized on the exchange. These rules apply on a shareholder-by-shareholder basis, so that one shareholder's treatment is not dependent upon the consideration received by, or the treatment accorded to, any other shareholder.

Rules also are provided to cover collateral areas such as selectivity, the treatment of purchase premium in taxable acquisitions, acquisitions from related parties, the treatment of creditors, and transfers (including incorporating transfers) to controlled corporations.

General Discussion

Under present law, a corporate acquisition is either a "reorganization" -- in which case it is a nonrecognition, carryover basis transaction at the corporate level, and, to the extent of qualifying consideration received, a nonrecognition, substituted basis transaction at the shareholder level -- or it is a taxable transaction -- in which case it is a cost basis event at both corporate and shareholder levels, but may be taxable only at the corporate or shareholder level. The Staff justifies its proposal in part on the grounds that the rules which distinguish tax-free reorganizations from taxable transactions are irrational, unduly complex, and lead to abuse.

The Treasury Department supports continued development of the acquisition proposals. These proposals have substantial merit in that they would provide greater consistency and symmetry to the tax treatment of corporate acquisitions. The principal defect of present law is that it relies too heavily on form and corporate procedures in determining tax consequences. We agree that it is very difficult to justify the present rules which define and differentiate various types of acquisitive transactions. The proposals reflect the view that similar transactions ought to be treated similarly, and that the tax law ought to be neutral regarding the transaction's form.

We are not convinced, however, that the rules of present law are unduly complicated. Rather, it is the environment in which those rules operate which is complicated. Corporate structures, and the nontax relationships between those structures and the owners of the enterprise, can be enormously complex. Moreover, acquisition transactions themselves may be extremely complicated. Therefore, it must be recognized that any set of rules created to apply in this area will be complicated in operation. We are not convinced that the proposals themselves will prove simple upon application.

We also are not persuaded that the acquisition provisions of current law have been the subject of systemmatic abuse. Indeed, these provisions have operated rather efficiently during their long history. While abusive transactions have occurred, legislative response has often been swift. Indeed, the corporate provisions enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") were directed, in part, at a series of specific identified abuses. We are not aware that those provisions have not proven effective.

Finally, it must be recognized that the change in the rules itself will necessarily cause dislocations for a substantial period of time. The basic structure of the acquisition rules can be traced back to 1918, and the present provisions have spawned an extensive body of case law, regulations, and published revenue rulings to aid in their interpretation. While the present rules occasionally operate in an irrational manner, they are generally understood by practitioners and have been used to effect transactions on a relatively routine basis over a substantial period of time. In contrast, taxpayers would likely be without substantial interpretative guidance for an extended period if new rules were enacted. Given the breadth of this project, the absence of that guidance could prove serious.

Corporate Level Electivity

The Treasury Department supports giving corporate buyers and sellers of businesses the choice of having the sale treated as either a taxable or tax-free transaction. We also agree that this choice should be available without regard to whether the transaction takes the form of the purchase of the business assets or the stock of the corporation conducting that business.

Under present law, a corporate purchaser may acquire a stepped-up basis in Target's assets either through a direct taxable purchase of those assets or through the taxable purchase of Target shares followed by a section 338 election. A carryover of tax history and asset basis can be obtained under present law through a tax-free or taxable purchase of Target shares (provided no section 338 election is made in the latter case), or through an asset acquisition which satisfies one of the tax-free reorganization provisions. We agree that, in practice, taxable or tax-free treatment is now generally electable if the parties follow the forms prescribed by the statute and interpretative authorities. That reliance on form, however, tends to reward the well-advised and to trap those who may not be aware of the nuances of the present provisions. We believe that the law would be improved if the results of an acquisition were explicitly elective, and did not depend on the form of the transaction. This is what the proposal provides, and the Treasury Department endorses it.

General Utilities

We strongly believe, however, that corporate level electivity is proper and appropriate only if Target is required to recognize its gains and losses in any case where a taxable election is made. Thus, the *General Utilities* doctrine must not be applicable in these cases. Under that doctrine, which stems from the Supreme Court's decision in *General Utilities & Operating Company v. Helvering*, 296 U.S. 200 (1935) -- and which is now codified in sections 311, 336 and 337 of the Code -- a corporation generally does not recognize gain or loss on the distribution of property to shareholders or on sales of property incident to complete liquidations. However, as further explained below, we also believe that it is inappropriate to impose both a corporate level tax and a separate shareholder tax on gains realized on liquidations. Our present view is that relief from the shareholder level tax should be afforded through the means of a tax credit.

Gain and loss recognition by Target is a necessary consequence of a taxable election for a number of related reasons. First, it makes symmetrical the tax treatment of each corporate party to the transaction If Acquiring is to receive a stepped-up basis for the assets of Target, gain or loss should be recognized, measured and characterized by reference to those assets in the hands of Target. Secondly, if asset basis were stepped up in corporate solution without a corresponding tax, the amount of the step up effectively would be removed from the corporate tax base. Finally, under the proposals, the corporate parties can elect to step-up the basis of the acquired assets even though the Target shareholders are not taxed upon the receipt of Acquiring stock. Failure to impose a corporate tax in such circumstances would cause a significant reduction in the tax base with no immediate tax to any of the parties to the transaction. Under present law, this result is not possible, as nonrecognition of gain at the shareholder level is allowed only if the transaction proceeds on a carryover basis at the corporate level, and a basis step-up at the corporate level is permitted only if the Target shareholders (and possibly Target) recognize gain and loss.

The symmetry between basis step-up and gain recognition provided by repealing the General Utilities doctrine would significantly improve the system for taxing corporate acquisitions. Present law generally imposes a tax only at the Target shareholder level, measured by the difference between the amount realized and the Target shareholders' basis in their stock. Additionally, the tax generally is imposed at capital gain rates since it derives from the shareholders' sale of stock. The proposed repeal of the General Utilities doctrine would result in the tax being measured by reference to Target's corporate-level basis in the acquired assets, and would characterize the income recognized by reference to the nature of those assets in the hands of Target. Accordingly, we believe the proposed repeal of the General Utilities doctrine is conceptually correct.

The present system, in contrast, produces completely random results. For example, the step-up in basis to fair market value at the death of a shareholder, or direct market purchases of stock, may cause stock basis to be high relative to corporate asset basis. In other cases, Target's shareholders may be in higher or lower tax brackets than the corporation or may be exempt from U.S. tax altogether. Similarly, where a direct sale of certain corporate assets would produce ordinary income, it is difficult to justify a system of taxation which limits the tax to the shareholders' capital gains on their stock. Indeed, it was just this disparity in treatment which led to enactment of the collapsible corporation provisions of section 341. Thus, a beneficial consequence of repealing the General Utilities doctrine would be that those complicated rules also could be repealed.

The repeal of the General Utilities doctrine in the context of acquisitions would result in two levels of tax being imposed on the disposition of a business; Target would recognize gain measured by its basis in its assets, and Target's shareholders would recognize gain by reference to their basis in their Target stock. Thus, the taxation of corporate acquisitions would be brought more in harmony with the present statutory scheme of twice taxing corporate operating profits; once when earned at the corporate level and again when distributed to shareholders. As stated in my introductory comments, consideration must be given to whether double taxation of corporate income is always appropriate. Even if full double taxation of operating profits is acceptable, it is arguable that double taxation of liquidating proceeds results in excessive taxation, particularly to the extent that the gain relates to appreciation in value of the corporation's original capital.

The Treasury Department believes that relief from the double tax must be continued in the acquisition context. It would seem preferable, however, for the reasons discussed above, for that relief to be provided at the shareholder rather than the corporate level as under present law. We believe that consideration should be given to providing Target's shareholders with a tax credit appropriately measured by reference to the tax paid by Target. In this respect, we note that the American Law Institute in its Federal Income Tax Project on Subchapter C also proposed a form of shareholder credit.

The shareholder credit appears to be an appropriate solution because it ensures that one, but no more than one, tax is paid, and measures that tax by reference to the assets whose basis is stepped up. Moreover, to the extent the appreciation in value of a shareholder's stock simply reflects the appreciation in value of the corporation's assets, a shareholder credit precludes double taxation of that asset appreciation. The shareholder credit also meshes well with the repeal of the General Utilities doctrine. Thus, the one tax that would be collected would be exacted at the corporate level and would be determined without regard to a shareholder's stock basis, its tax status, or its marginal tax rate.

While we generally support the shareholder credit approach, we recognize that it presents complexities which remain to be worked out. For example, requiring the corporation to compute the amount of credit available for each shareholder, and to inform each of the credit to which he is entitled, may prove to be a complex task for corporations with numerous shareholders whose composition changes daily, especially with respect to sales which occur prior to the acquisition. In addition, it is unclear how the credit mechanism should operate where a shareholder cannot use the credit because losses offset the shareholder's gain realized on the acquisition, or where a shareholder receives stock which results in nonrecognition at the shareholder level. It also may not be appropriate to provide relief from the double tax on gains which resemble mainstream profits (e.g., gains on inventory and other short-held assets). Nevertheless, we believe the shareholder credit is the approach which should be explored to provide appropriate relief from the double tax.

We believe that the other relief measures proposed by the Staff may not be workable or appropriate. The Staff has set forth four options (other than a shareholder credit) which may be considered if relief to double taxation is to be provided on a permanent basis. First, they suggest that certain historic assets could be exempted from the corporate tax. Alternatively, an election could be provided on an in kind liquidation distribution to permit the deferral of the corporate or shareholder tax (or both) until the assets are disposed of by the shareholders. Thirdly, the corporate capital gains rate might be reduced. Finally, a reduction in the individual capital gains rate could be provided. The Staff also has proposed a form of transition relief which would phase in the corporate capital gains tax on certain assets over a 12-year period.

For reasons I have described, we do not believe it is appropriate simply to exempt certain assets from corporate tax if those assets are to receive a fair market value basis in corporate solution. Similarly, while (as I will develop later) deferral of tax on liquidations in kind may be appropriate, that solution is not available in many cases, including the simple case of a sale for cash followed by distribution of the proceeds. Reducing the tax rate on corporate or shareholder capital gains generally would minimize the burden of the double tax, but does not respond directly to the problem of double taxation. Finally, we believe the issue is more than transitional. The question is whether there ought to be a double tax on gains realized in the course of corporate dispositions. Phasing in a double tax system provides relief to those who invested in corporations in reliance on the existing structure, but does not the address the underlying issue.

Another aspect of transition relief bears mentioning, however. Even under an approach which imposes only a corporate (rather than a shareholder) tax on dispositions, the tax burden could be greater than under present law. Presently, the maximum tax cost of disposition is shareholder level gain plus certain recapture items which also are taxed at the corporate level (e.g., depreciation, investment tax credit, LIFO inventory). Because of date of death step-up or recent market purchases, stock basis may be high relative to asset basis. Further, recapture items may not be significant if inventories are on a FIFO basis or real estate has been held for substantial periods. Accordingly, the burden of a corporate level tax could be greater than the tax imposed under present law. That burden is enhanced by the fact that the present shareholder tax is generally imposed at capital gains rates (now a maximum of 20 percent for individuals), while corporate gain on inventories or similar assets would be taxed at the corporate ordinary income rates (presently a maximum of 46 percent). Of course, the tax burden relative to present law would be even heavier if only limited relief from double taxation is provided. Indeed, under the credit, exemption, or phase-in proposals described in the Staff report, the relief would be limited to the double tax on long-held, capital gain assets, and generally would not apply to gains on shorter-held, ordinary income type assets, such as inventories.

Thus, those who have relied on the existing structure in planning their affairs would be subject to a greater tax burden on disposition than previously thought. While every change in the tax laws has this effect to a greater or lesser extent, in light of the broad impact of this project, the Committee might want to consider whether a deferred effective date or other transitional relief should be provided.

Shareholder Consequences

We see no necessary connection between the treatment of an acquisition transaction at the corporate level and the treatment of the exchanging shareholders. There is no incongruity between treating the transaction on a nontaxable basis as between the corporate parties and as a taxable, recognition exchange at the shareholder level. Indeed, this result can obtain under present law upon a cash purchase of shares. Similarly, the parties' decision to treat the transaction on a cost basis need not dictate the results to the shareholders.

Under the Code, the taxability of corporations and shareholders are two separate matters. Corporations are taxed when profits are realized and shareholders are taxed when distributions of those profits are made or stock is redeemed or sold. We believe that upon a corporate combination, taxation should not be required if a shareholder receives a continuing equity interest in the venture. We recognize the argument that, when Target is significantly smaller than Acquiring, in fact, an exchange for new and wholly different property has occurred on which taxation should result. In this connection, it might be noted that in formulating the 1954 Code, the House of Representatives would have denied tax-free treatment to mergers or consolidations, other than those between "publicly held corporations," unless the shareholders of Target received at least 20 percent of the stock of the resulting corporation. That provision was not enacted in part because of various problems involved in defining a publicly held corporation. We also believe that it is impossible to draw appropriate lines in this area which will meaningfully distinguish a tax-free continuing investment from a taxable sale.

Accordingly, The Treasury Department agrees that, whatever election is made at the corporate level, shareholder treatment should depend on the nature of the consideration received. Instruments that represent a continuing, equity involvement with the assets of the acquired enterprise, such as stock of Acquiring or its parent, should be received free of tax. Similarly, receipt of consideration other than stock should have tax consequences usually attending that of a distribution by an ongoing corporation to a shareholder.

Thus, we agree that the rule of section 356(a) of the Code, which limits dividend income to recognized gain, should be eliminated. If a distribution has the effect of a dividend it is difficult to see why dividend treatment should be limited to the excess of the amount received over basis. No such limitation applies under current law with respect to ordinary distributions, and the rules for distributions attending corporate combinations should be harmonized with those governing ordinary distributions to the greatest extent possible.

We also note that the proposal determines dividend equivalence by assuming that the Target shareholders first transfer all of their stock for stock of Acquiring and then have a portion of that Acquiring stock redeemed. This rule, which looks to the shareholder's reduction in interest as measured after the acquisition, would essentially codify the result in Wright v. United States, 482 F.2d 600 (8th Cir. 1973). As such, it rejects the approach which looks to the distribution as if it were made by the Target, and which determines dividend equivalence based on the reduction in relative interests before the acquisition. Shimberg v. United States, 577 F.2d 283 (5th Cir. 1978); Rev. Rul. 75-83, 1975-1 C. B. 112.

Resolution of this issue is a very close call. On the one hand, since the nontaxability of the receipt of Acquiring stock is premised on the assumption that the Target shareholder continues his investment in the enterprise, and since cash is essentially fungible, arguably the distribution should be treated as having been made by the Target to its shareholders. Further, where the distribution is to a controlling shareholder of Target who may have engineered the transaction, it may be argued that the dividend determination should be made completely by reference to the shareholder's interest in Target. In this connection, it might be noted that under the Staff's proposal the instances of dividend treatment would be greatly reduced relative to the pre-acquisition approach, both for controlling shareholders and others. On the other hand, a strong argument may be made that any reduction in a shareholder's interest should be measured by taking into account the overall transaction, and therefore the relevant determinant is the shareholder's interest in the resulting enterprise.

On balance, we do not object to the Staff's recommended approach in the context of the overall project. Since, however, (as explained below) we oppose repeal of the earnings and profits limitation on dividend income, if the post-transaction approach is to be adopted, the measure of dividend income should be determined by reference to the earnings and profits of the combined enterprise.

Finally, we note that the proposal eliminates the present nonstatutory constraints on tax-free reorganization status, such as continuity of interest, business purpose, and continuity of business enterprise. We agree that continuity of interest and business purpose may be eliminated in the new structure. However, we are concerned about the complete abolition of the role of continuity of business enterprise in tax-free acquisitions. For example, if Target sells all of its assets for cash and then merges into Acquiring, it may be appropriate to tax Target shareholders on the receipt of Acquiring stock, as the Target shareholders arguably retain no continuing interest in the Target enterprise upon which nonrecognition of realized gain can be justified. By the same token, however, we recognize that it may be difficult to distinguish cases where a continuing investment in fact exists from those in which it does not. Section 368(a)(2)(F) of the Code, in part, deals with this situation in certain mergers involving investment companies. We note that the proposal would retain the rules of section 368(a)(2)(F). Perhaps those rules could be expanded to cover other, similar transactions not presently within its scope.

Selectivity -- Unallocated Acquisition Premium

The acquisition proposals allow taxable or tax-free elections to be made on a corporation-by-corporation basis. Thus, an election could be made with respect to a subsidiary of Target that is different from the election made with respect to Target. An anti-tax avoidance rule generally extends any election as to one corporation to all assets held by that corporation within one year of the acquisition. In addition, "unallocated acquisition premium" (generally goodwill) could be the subject of a tax-free election, with concomitant carryover basis, even though a taxable election is made. These rules represent a substantial liberalization of the consistency rules of present law contained in section 338, which generally require that the step-up in basis or carryover basis election be made as to all or none of the acquired assets.

We have some reservations about these proposals. First, it must be recognized that the corporation-by-corporation approach imposes no serious limitation to selective treatment of assets. If the seller has the foresight to lodge assets in separate corporations more than one year before the disposition, free selectivity will result.

We are concerned that the ability to achieve a cost basis on some assets and a carryover basis on others may make acquisitions more attractive. As we testified before this Committee on July 15 of last year, the ability to pick and choose as to asset basis (with the pre-TEFRA tax consequences) had been abused and had provided an incentive for certain corporate acquisitions. Since potential ACRS deductions make some assets (especially real estate) more valuable to buyers than to sellers, the tax laws provide some incentive for the sale of those assets. When some desired assets are acquired with a basis step-up, while other desired assets are acquired without triggering any tax detriment, the incentive escalates. The consistency rules enacted as part of TEFRA were a response to that problem.

In that testimony, the Treasury Department also recognized that a repeal of General Utilities might be a viable solution to the selectivity problem. When a corporate level tax is paid in connection with an acquisition, the advantage of a basis step-up diminishes. We are concerned, however, that repeal of General Utilities might not totally eliminate the problem. If, for example, gain on long-held depreciable assets is exempted from tax (or is phased in over a substantial period), the problem would exist with respect to those assets. Indeed, even if a shareholder credit is provided, so that only a corporate tax is imposed, an incentive may still exist to the extent that the value of the purchaser's deductions exceeds the seller's tax paid.

In any event, the degree of the problem will depend upon the extent of the tax imposed on the sale. Thus, no anti-selectivity rule can be fashioned until the system for providing relief from the General Utilities repeal, if any, is decided upon. At that point, the identified abuse sought to be restricted must be balanced against any increased complexity created by the remedial rule.

The proposal also provides an exception to the corporation-by-corporation consistency rule for so-called "unallocated acquisition premium," which is defined as the excess of the purchase price over the value of the assets acquired. This amount is generally intended to represent purchased goodwill. Under this exception, in an otherwise taxable transaction, Acquiring could elect a carryover (generally zero) basis for this item, and Target would recognize no gain on the sale of that item. This rule provides some relief from the repeal of General Utilities in taxable acquisitions.

As stated above, we believe that relief from double taxation would best be provided through means of a shareholder credit. We also have some concerns about the implications of the proposal. If the parties have a free rein in making the allocation to purchase premium, substantial flexibility would be provided to determine asset basis. That flexibility is inconsistent with the selectivity rules generally, and with the premise that basis should reflect the price paid. In this connection, it should be noted that a similar goodwill allocation in the partnership context (section 736) must be reasonable in amount. Treas. Regs. § 1.736-1(b)(3). It is also difficult to see why goodwill should be treated differently from other assets. The theory of the acquisition proposal is that, in a taxable acquisition, Acquiring starts fresh with all assets acquired, and inherits none of Target's tax history. A further premise is that corporate tax is paid on the basis acquired. We are not certain that goodwill should be accorded different treatment. The proposal also does not make clear what items would be covered by this allocation. If the justification for the suggested special treatment is that Acquiring will derive no tax benefit from this asset, it is difficult to see why other nondepreciable or nonamortizable property, such as other intangibles or land, should be excluded from the rule.

Incorporation Transactions

Section 351 of the Code presently allows property to be transferred to a controlled corporation without recognition of gain to the transferor. This provision (which most often applies in incorporation transfers) is based on the premise that tax should not be imposed on the mere change in form (i.e., from a proprietorship or partnership to a corporation) of conducting business. The proposals retain section 351, but tighten the present rule relating to the receipt of debt securities to parallel the rule which applies in the acquisition context.

Presently, transferors may receive securities under section 351 with no immediate tax, while in acquisition transactions securities may be received tax-free only to the extent of the principal amount of the securities surrendered.

The preferential treatment of debt securities in a section 351 transaction should be abolished. An exchange of property for debt is an appropriate occasion for taxation. Further, the availability of installment reporting prevents any undue hardship on the transferor. In addition, the favorable rule in the section 351 context has resulted in acquisitions being cast in the form of section 351 exchanges in order to secure its benefits. The Treasury Department supports conforming the securities rules for incorporation and acquisition transactions.

Further Comments

Finally, we note that no specific proposals are made with respect to other transactions now affected by the rules of Subchapter C. For example, section 355 contains detailed provisions regarding corporate divisions. Similarly, specific rules governing restructuring of bankrupt corporations are now provided. We believe that these, as well as other, rules must be carefully reexamined if basic changes are made to the corporate tax provisions. The rules of corporate taxation are an integrated whole. If changes are made to certain of the basic provisions -- for example, the rule of General Utilities -- those changes will reverberate throughout the system. Some provisions previously thought necessary to prevent abuse may no longer be relevant; others may have to be redrawn and strengthened. Accordingly, we believe that a fundamental restructuring must take into account all collateral consequences.

The Liquidation Proposals

Under the proposals, liquidations in kind generally are treated the same as taxable acquisitions. Thus, the liquidating corporation recognizes any gain or loss inherent in its assets. Additionally, the shareholders receive a fair market value basis for those assets and recognize the gain or loss realized on disposition of their stock. Although the proposal does not specifically address the point, presumably no special election with respect to goodwill is permitted.

The Staff justifies this proposal on the grounds that it is necessary to be consistent with the acquisition proposal, and that it will achieve substantial simplification by allowing repeal of the collapsible corporation rules. Further, it is asserted that the opportunity afforded by present law to create depreciable basis at the cost only of a shareholder level tax is unduly favorable, resulting in less tax being imposed than if no corporate tax existed, and causing tax-motivated liquidations and liquidation-reincorporation transactions to occur.

The Treasury Department believes that a double tax on an in kind liquidation distribution of an ongoing business to its historic shareholders is inappropriate and that some relief is warranted. The Staff report recognizes that:

"[L]iquidation of a corporation is often a highly formal step without economic substance. After a liquidation, in general, shareholders have substantially the same economic interest as before."

As noted, under present law (and under the proposals), gain or loss is not recognized in incorporation transfers on the theory that the mere change in form in the conduct of a business is not an appropriate realization event. Similarly, there would seem to be at least some circumstances involving a change in form out of corporate solution where taxation -- indeed, double taxation -- of asset appreciation is inappropriate. We believe that a structure should be provided to permit a tax-free unwind of a corporation under appropriate circumstances.

The Staff recognizes that relief may be needed in some circumstances. Their solution is to trigger the corporate level tax while deferring the shareholder tax though a substitution of the shareholders' stock basis for the corporation's asset basis.

We suggest that consideration be given to structuring the relief in a somewhat different manner. We are not convinced that an immediate tax need be exacted from the corporation on liquidation, just as it is not necessary to exact a tax on incorporation. If the corporation's asset basis carries over in the hands of the shareholders, the potential for the one tax that ought to be imposed remains intact. Thus, the shareholders could be provided with an election, parallel to the one available in acquisitions, in which the liquidating corporation recognizes no gain or loss and the shareholders take a carryover basis for the corporation's assets. Preservation of the corporate level tax through the carryover of asset basis should be adequate to prevent abusive liquidation-reincorporation transactions. However, a condition to this election might be that the basis of the assets received could not be stepped up to fair market value at the death of the shareholder. In addition, it may be inappropriate in some cases to permit a tax-free withdrawal of corporate earnings. Accordingly, a further feature of the carryover basis election could be that gain will be taxed to the extent of the undistributed earnings received.

In this connection, it might be noted that the Subchapter C Advisory Group proposed a somewhat similar provision in its 1959 Recommendations on Corporate Distributions and Adjustments. The Advisory Group proposed that, on liquidations, shareholder gain would be recognized only to the extent of the excess of the corporation's basis of the assets distributed over the shareholders' basis of the stock surrendered (plus liabilities assumed). Similarly, under that proposal, the shareholders' basis for the assets received generally would be the greater of the corporation's basis in those assets or the shareholders' basis in their stock.

We recognize that there may be problems with the approach we propose. First, in some cases, it may provide different results than those which obtain in acquisition transactions. To the extent the rules are different, discontinuities will result. Indeed, just as present law differences between incorporations and acquisitions have caused transactions to be cast in the former mode, so might distinctions between disincorporations and acquisitions cause taxpayers to structure transactions to achieve the more favorable result. In this connection, we also note that those judicial doctrines which have been jettisoned in the acquisition proposal, such as continuity of interest and continuity of business enterprise, may have to be applied to liquidations in kind.

Nevertheless, we believe that, if possible, an election should be provided so that certain in kind liquidations of a business will not be taxable at the corporate level. We would like to work with the Staff to see if this result can be obtained.

The Distribution Proposals

Repeal of General Utilities

The proposals also provide for the repeal of the General Utilities doctrine in the distribution context. Thus, a corporation would generally recognize gain on a distribution of appreciated property to its shareholders, whether the distribution is by way of a dividend or is in redemption of shares. (No gain would be recognized, however, on an intercorporate dividend distribution, since the carryover basis to the distributee preserves the gain inherent in the property.)

The Treasury Department supports this result. Last July, we testified before this Committee in strong support of rules (enacted as part of TEFRA) which would tax the distributing corporation on gain recognized on the distribution of appreciated property in redemption of stock and in partial liquidation. That support was based on the belief that there is no reason for a difference in result where property is sold by the corporation and the proceeds distributed, and where the property is distributed in kind. That reasoning also supports requiring the distributing corporation to recognize gain on a dividend distribution.

This result also will achieve simplicity and consistency. Corporations generally are taxed on distributions of appreciated property in redemption of stock. However, that general rule does not apply to certain distributions made to significant historic shareholders. The policy underlying that exception is questionable, and the exception itself introduces additional complexity to the Code. Further, under some circumstances, dividend distributions *are* taxed to the distributing corporation. For example, a distribution in redemption of stock which does not qualify for exchange treatment under section 302(a) results in recognition to the distributing corporation. It is difficult to see why the fact of a redemption is relevant to this result. The significance of a redemption is particularly questionable in light of the fact that a distribution in partial liquidation which is accorded exchange treatment under section 302(b)(4) may nonetheless trigger gain to the distributing corporation even if the shares are not surrendered in the transaction.

Repeal of the Earnings and Profits Limitation on Dividend Income

Under present law, a distribution is a taxable dividend to the shareholder only to the extent of the corporation's current or accumulated earnings and profits. The purpose of the earnings and profits limitation is to subject to dividend tax only distributions of a corporation's profits, while allowing tax-free the return of the shareholder's capital. The proposal would repeal the earnings and profits rule, subjecting to dividend treatment all distributions other than redemptions treated as exchanges. As a relief measure, certain tax-free returns of capital would be allowed if made to the contributing shareholder within 3 years of the contribution. The Staff bases the proposal on certain apparent abuses in the earnings and profits computation, and the complexity of earnings and profits accounting.

The Treasury Department opposes the repeal of an earnings and profits limitation on dividend income. We believe that the principle of the limitation -- which is to subject to shareholder tax only a distribution of corporate earnings -- continues to be valid. That is not to say that the present rules operate correctly in every case. However, to the extent defects exist, the appropriate response is to identify and rectify the sources of the problem, rather than to scrap the principle altogether.

For example, the Staff identifies as one source of manipulation the case where a corporation borrows against the unrealized appreciation in its assets and distributes the proceeds to its shareholders. Since earnings and profits are not increased to reflect the borrowing, the distribution is not necessarily taxable to the shareholders. If this device is determined to be abusive, it could be curtailed by a simple amendment to section 312. Indeed, the Code presently contains a provision to cover an analogous situation. Under section 312(i), receipt of a Federally-guaranteed loan which exceeds the basis of the securing property increases earnings and profits by the amount of the excess. A similar provision might apply to other borrowings.

Additionally, the Staff notes that, because earnings and profits are tied to taxable income, improper results obtain to the extent that taxable income does not reflect financial earnings. As an example, the report cites the case of certain defense contractors who made periodic, non-taxable distributions, because the deferral of income and accelerated deductions available under the completed contract method of accounting eliminated their earnings and profits accounts.

We note that TEFRA made certain changes to the completed contract rules which will limit discontinuities between earnings and profits and financial income. However, to the extent distinctions remain, we believe that the appropriate response is to examine those features of the tax laws which cause the disparities to exist, and to consider the role that special rules and methods of accounting should play in determining earnings and profits. Another response could be to have earnings and profits determined in the first instance on financial rather than tax earnings. Repealing the limitation, however, in our opinion, is a misdirected means of rectifying the perceived abuse.

While, for some, repeal of earnings and profits will achieve a degree of simplification, we are not convinced that repeal would significantly reduce any existing complexity. We note that, even if the concept is repealed for purposes of determining dividend treatment, earnings and profits (or a similar computation) will still be required for other purposes of the Code, such as the measure of recapture under section 1248. Finally, to the extent complicating rules do exist, again, we would rather attempt first to simplify the rules themselves. Eliminating the concept altogether is an overbroad response.

Additionally, we are not certain that repeal would be constitutional, or even if constitutional would be supported by any degree of fairness. To choose a simple example assume Mr. A forms corporation X and invests $1,000. Over a 3-year period, X breaks even, so that A's $1,000 represents all of X's assets. If A withdraws $200 from X, we have difficulty viewing A as having any accretion to wealth on which an ordinary income tax should be imposed.

Finally, we fear that taxing all distributions on equity as dividends will put further pressure on the debt-equity distinction. While distributions on both would be taxable to the shareholder, the corporation could deduct only those payments made on the debt. Our experience in developing regulations under section 385 has shown that distinguishing debt from equity is no easy matter. We are loathe to support any rule which tends to increase further the tax advantages that debt instruments have over equity instruments.

Corporate Dividends Received Deduction

The Staff identifies two areas of concern in relation to the functioning of the 85 percent dividends received deduction available to corporations. The corporate dividends received deduction is provided in order to prevent the imposition of multiple taxation as dividends pass from one corporation to another. In general, under the present scheme for taxing corporate operating profits, such profits should be subject to a first "mainstream" tax on income from operations, and a second shareholder level tax as the earnings are distributed to noncorporate shareholders. The corporate dividends received deduction thus assures that, in general, significant additional tax is not imposed on intermediate distributions to corporate entities.

Circumvention of Restrictions on the Dividends Received Deduction

The first area of concern identified by the Staff relates to possible opportunities to obtain the benefit of the dividends received deduction in certain cases in which the "dividend income" effectively had matured prior to the taxpayer's acquisition of the dividend-bearing shares. For example, a taxpayer might acquire shares of stock immediately prior to the time the shares became ex-dividend, and, following the ex-dividend date and the predictable drop in value of the shares by an amount approximately equal to the dividend, sell the shares at a loss. (Because the holder of the shares on the ex-dividend date is entitled to receive the dividend distribution, the price of the shares drops immediately after the shares become ex-dividend.) The taxpayer then could claim that the dividend income is 85 percent tax-exempt (due to the dividends received deduction), while the short-term loss on the shares is allowable in full against unrelated capital gain income. Thus, a taxpayer would receive dividend income of $1, subject to a tax of $0.069, and experience a short-term capital loss of $1, having a value as a tax benefit of $0.46. The net tax benefit of this transaction is $0.39 ($0.46 - 0.069) per dollar of dividend income.

The existence of this tax arbitrage opportunity was recognized by the Congress in 1958. In response to the problem, the availability of the dividends received deduction was conditioned on a taxpayer's holding the shares producing the dividend for more than 15 days, on the theory that the taxpayer would be exposed to significant market risk during that period. The risk associated with holding the shares for 15 days was viewed as adequate to deter taxpayers from engaging in transactions, such as the one described above, in order to obtain improper tax advantages. The 1958 amendment also provided for a 90-day holding period where a dividend on preferred stock was attributable to a period exceeding one year. This rule is justified on the premise that a larger dividend combined with a smaller likelihood of price fluctuation in the shares (than would be the case for common stock) presents a greater opportunity to obtain tax arbitrage benefits that are disporportionate to the market risk borne by the taxpayer. Finally, the 15- and 90-day holding periods are considered not to run for any period during which the taxpayer has insulated itself against risk of loss in holding the shares by reason of its also holding a put, a fixed obligation to sell, or having entered into a short sale, with respect to "substantially identical" stock or securities. This tolling rule during periods that the taxpayer has a reduced risk of loss follows logically from the purpose of the holding period rules to ensure that tax arbitrage is foreclosed automatically where the taxpayer does not accept the degree of market risk prescribed by the statute.

Two problems in the functioning of the restrictions on the 85 percent dividends received deduction have come to light:

- In cases where a dividend is paid that is large in relation to the trading price of the shares, the 15- and 90-day holding periods may not provide sufficient market risk to counterbalance the tax arbitrage opportunity.
- Various techniques may allow taxpayers to reduce materially the risk of loss of holding shares without taking a position in "substantially identical" stock or securities, as that term is defined. In these cases, the policy underlying the 15- and 90-day holding period rules is frustrated.

To deal with these apparent opportunities to benefit from tax arbitrage through the use of the dividends received deduction, the Staff proposes that a one-year holding period be established in order to qualify for the dividends received deduction. The report states that "[t]echnical changes would also be made to tighten the rules for computing such holding period," but does not specify the nature of those technical changes.

We concur with the general approach of the Staff in dealing with these apparent opportunities to utilize the dividends received deduction to produce improper tax arbitrage. We wish to suggest some modifications to the specific proposals however. Initially, we agree that introducing greater market risk as the "price" of obtaining the dividends received deduction is an appropriate means of dealing with the tax arbitrage opportunity that may be presented where large dividend distributions are made. Our preference, however, would be to deal with such cases by a more targeted means than a general lengthening of the required holding period. Thus, we suggest that the holding period should be lengthened only in cases involving relatively large dividend distributions, because such cases appear not to be dealt with adequately by the present 15- and 90-day holding period rules. We are not able at this time to evaluate the appropriateness of the suggested one-year holding period. However, some period substantially in excess of 90 days is certainly is called for. Moreover, consideration might be given to requiring that the stock be held for a substantial period of time prior to the distribution in order for the taxpayer to qualify for the dividends received deduction.

Secondly, in the case of large dividend distributions where the taxpayer does not hold the shares for the required period, we would favor an approach that would recognize that the purchaser of the shares in substance is acquiring two separate assets. To illustrate this point, assume that a share of stock is trading at $38 and that an $11 dividend has been declared. The new holder can be viewed as paying approximately $11 to acquire the right to receive the $11 dividend distribution and $27 for the underlying stock. Following this approach, the purchaser's basis in the underlying shares should be only $27 (the $38 purchase price reduced by the amount of the dividend payment), with the result that a subsequent sale of the shares will produce no gain or loss other than as a result of actual market fluctuations subsequent to the purchase. In our view, this basis allocation rule corresponds to the economic substance of the transaction and accords with general tax principles.

Thus, to deal with the perceived abuses which have arisen in the context of large dividend distributions, we suggest that consideration be given to reducing a corporate taxpayer's basis in acquired shares by the amount of the dividend if (i) the dividend exceeds some material percentage -- such as 5 percent -- of the trading price of the shares (immediately prior to the shares becoming ex-dividend), and (ii) the taxpayer ultimately does not hold the shares for the required period. A recapture-type rule would be needed for cases where the shares are disposed of after the tax return for the year was filed and prior to the passage of the required holding period.

We also agree with the Staff that existing law may be inadequate to deal with techniques in which taxpayers reduce materially the risk of loss of holding stock investments without taking a position in "substantially identical" stock or securities. The difficulty with the present rule derives from the assumption that market risk may be reduced materially only through positions in stock or securities which are "substantially identical" -- a term that has been construed narrowly. A more appropriate rule would take a functional approach, and inquire whether the taxpayer has substantially diminished its risk of loss of holding the stock by reason of its holding another "position," whether or not the latter position is held in substantially identical stock or securities. We note that the standard of "substantial diminution of . . . risk of loss from holding [a] position . . . by reason of . . . holding 1 or more other positions" was utilized by the Congress in the tax straddle rules enacted in Title V of the Economic Recovery Tax Act of 1981. The purpose of the substantial diminution of risk rule in the 1981 Act parallels closely the objective of the tolling rules applicable to the dividends received deduction. Accordingly, we believe it would be appropriate to consider utilizing the substantial diminution of risk standard in the context of the dividends received deduction.

In summary, we do not favor an across-the-board extension of the holding period to qualify for the dividends received deduction. We believe that legislation consistent with the suggestions outlined above would eliminate unjustfied tax arbitrage opportunities by ensuring that (i) the market risk entailed in qualifying for the dividends received deduction bears an appropriate relationship to the magnitude of the dividend, and (ii) the holding period rules requiring the taxpayer to accept a measure of market risk to obtain the dividends received deduction may not be avoided. We are not persuaded at this time that cases not brought within these strictures present a significant tax avoidance opportunity warranting a general extension of the 15- and 90-day holding periods of present law.

Leveraged Stock Acquisitions

The second issue raised in the report in relation to the functioning of the dividends received deduction involves transactions in which taxpayers incur or continue indebtedness to purchase or carry corporate shares that will yield dividend income. The availability of the dividends received deduction, coupled with a deduction for "offsetting" interest expense, again can produce unintended tax benefits. To illustrate the problem, assume that X Corp. borrows $100 at 10 percent annual interest to buy $100 of stock paying an annual dividend of $11. The after-tax cost of the annual interest charge is $5.40 ($10 - ($10 x .46)). The $11 dividend income will result in $10.24 after tax ($11 - ($11 x (1-.85) x .46)). Overall, the investment yields a pre-tax return of $1, but an after-tax return of $4.84 ($10.24 - $5.40). Although there is some measure of economic risk associated with the investment position in the stock and the obligation to repay the debt, in certain cases these risks are diminished significantly by the use of nonrecourse borrowings and floating rate preferred stock investments. Even where these risk-reducing techniques are not employed, it is clear that these transactions can provide a corporate investor a substantial tax benefit that is not justified in many cases.

The Staff proposes to deal with the problem posed by these transactions by disallowing a corporation's deduction for interest on indebtedness incurred to purchase or carry corporate stock that will produce dividends qualifying for the dividends received deduction. An "objective rule" would be provided to ensure that the borrowing to purchase or carry the stock investment could not be disguised. The Staff does not suggest disallowance of interest deductions in connection with investments in controlled subsidiaries.

While we share the Staff's concern regarding leveraged stock acquisitions, it is our view that any solution to the problem posed by these transactions must be consistent with the fundamental concepts underlying the dividends received deduction. Because the proposed solution could produce results that are not consistent with the policy underlying the dividends received deduction, we must oppose the proposal.

The corporate dividends received deduction has long been a feature of the corporate income tax. As noted above, the purpose of the deduction is to prevent multiple taxation of dividend income flowing through corporate entities. To illustrate, if X Corp. earns $2 of income from operations, it will pay $0.92 of corporate tax. Assume X Corp. distributes the approximately $1 of earnings to its shareholder, Y Corp. In general, there should be no tax collected from Y Corp. because Y Corp. in turn will distribute the $1 as a dividend to its shareholder, individual A, who will pay the second tax on the corporate earnings. The absence of an exclusion mechanism at the Y Corp. level could result in triple or even greater taxation.

It should be noted that the allowance of an 85 percent dividends received deduction, instead of 100 percent, is inconsistent with this policy. The reason for the 15 percent taxability of dividends from non-controlled subsidiaries generally is said to be to discourage multiple corporation structures. However, as discussed below, 15 percent taxability also may be a justifiable policy result to the extent that the corporate dividend recipient is capitalized in part with debt.

Certain important assumptions underlie the assertion that the dividends received by Y Corp. in the above example generally should not be subject to tax. The most significant assumption is that the $1 dividend received by Y Corp. will be paid out by Y as a dividend. The failure to pay out dividend income in the form of a non-deductible dividend distribution undermines a critical premise of the dividends received deduction. The conjunction of the dividends received deduction with a deduction for the distribution in the form of an interest payment, will, overall, result in collection of only one tax on corporate earnings, instead of the two taxes generally required by current law. To illustrate this point, vary the above example by making an admittedly extreme assumption: assume A's interest in Y Corp.

consisted exclusively of debt, and that the equity interest in the corporation were nominal. Thus, Y Corp. would distribute the $1 dividend received from X Corp. to A in the form of deductible interest. A first tax would be collected at the X Corp. level, and a second tax would be collected (with respect to the interest received) from shareholder A. However, in addition to a deduction for the dividend received, Y Corp. would have an additional deduction for interest paid. In effect, a negative tax would be accorded to Y Corp., with the result that, overall, only one tax would be collected in the chain (disregarding the 15 percent taxability of the dividend received by Y Corp).

Obviously, the example is oversimplified, particularly in the assumption of 100 percent debt capitalization. It illustrates, however, that the predicate for allowing a dividends received deduction is the assumption that dividends received will be paid out in the form of a dividend. A further assumption would appear to be that the dividend distribution will occur relatively near in time to the receipt of the dividend income; taking into account the time value of money, it may not be appropriate to insulate Y Corp. from current tax where the distribution to A will not be made for a long period of time.

To summarize our view, the Staff's proposal to disallow the deduction for interest payments that are "matched" with dividend receipts has conceptual merit. However, a mechanical disallowance rule that does not take into account the character of the total payments made by the corporation with respect to its capital structure will sweep too broadly in some cases. For example, if the corporation receiving dividend income were capitalized almost exclusively with equity, it would not be proper to disallow deductions for interest expense simply because the corporation also holds equity securities that generate dividend income. A mechanical disallowance rule such as that proposed would achieve a proper result only if one makes the assumption that total distributions by the recipient corporation are made to a material degree in the form of interest. Such an assumption would not be correct in many cases.

An approach to the dividends received deduction that would conform more closely to the policy considerations supporting the proposal would be to link the deduction for dividends received to the distribution of those amounts in the form of a dividend. Such an approach could be drawn as a deduction for dividends paid to the extent distributions are made out of dividends received. A difficult problem with this approach is identifying the source of dividend distributions. One solution to the problem would be to assume that each dollar distributed as a dividend is comprised of income from each source earned by the corporation, and that the proportion of the dividend derived from a particular source is determined by the ratio of the amount of income from that source earned by the corporation to the total income of the corporation. Under this assumption, if a corporation earned $10 of dividend income and $90 of income from operations, a $10 dividend distribution would be considered as made $1 from dividend income and $9 from profits from operations, so that a $1 dividends paid deduction would be permitted. Alternatively, the assumption could be made that the $10 dividend distribution was made entirely from dividend income, so that a deduction of $10 would be permitted. Such a rule is no doubt simpler to administer, and may be supported to some degree by a logic that the "discretionary" funds available for distribution to shareholders are investment receipts.

We are not prepared here to recommend a dividends paid deduction in lieu of the current dividends received deduction. A proper tracing rule, which is fundamental to the concept of a dividends paid deduction, clearly requires further study. Moreover, a change in such a fundamental aspect of the corporate tax must be considered in light of the larger whole of corporate taxation, and the impact on investment practices including non-tax rules relating to debt-to-equity ratios and the like.

Payments in Lieu of Dividends

The Staff also describes a problem that is similar in concept to the tax arbitrage opportunities that may be presented by the corporate dividends received deduction where shares are acquired just prior to the ex-dividend date. The problem may be illustrated by an example used previously. Assume a stock is trading at $38; a dividend of $11 per share has been declared, and the stock is about to become ex-dividend. An individual borrows the shares and opens a short sale by selling the shares at $38. On the dividend payment date, the individual will be required to idemnify the lender of the shares for the dividend by paying him $11. ~~The~~reafter, the stock can be expected to drop in value by an amount reflecting the dividend payment, so that the short sale can be closed at $27, yielding a gain of $11. Under present law, the individual is permitted an ordinary deduction for the short sale expense of $11 under section 212 of the Code. Closing the short sale results in short-term capital gain of $11. The ordinary deduction may be utilized against wage or investment income, while the short-term gain may be offset by unrelated capital losses (which otherwise would be deductible against ordinary income only to the extent of $3,000 per year, and would not be deductible to any extent in the case of a corporation).

Again, our analysis of this transaction proceeds from the assumption that two assets -- the stock, and the matured dividend right -- were borrowed and sold. The payment of the short sale expense from the proceeds of the short sale constituted, in substance, a return of the matured dividend right to the lender. As such, the repayment of the dividend right should not give rise to a deduction; it merely represents the repayment of borrowed funds. The two asset analysis leads to the further conclusion that the amount realized on the short sale of the stock must be separated from the amount realized from the sale of the matured dividend right. Thus, closing the short sale in this example should produce no gain or loss (in the absence of actual market price changes after the short sale is opened). An alternative means of reaching the same result would be to deny a deduction for the dividend substitute payment and treat the amount of the dividend substitute payment as an increase in the tax basis of the short sale account, without bifurcating the short sale into its component parts.

The foregoing analysis is appropriate in our view where the person effecting the short sale borrows, and realizes on, a matured dividend right, rather than a right which accrues subsequent to the opening of the short sale. Take as an alternative example the case where A opens a short sale by borrowing and selling preferred stock, realizing $100 on the short sale. Assume that after one year, A is required to pay over the $10 dividend substitute payment to the lender of the shares. If there has been no market fluctuation in the value of the shares, A then will close out the short sale by buying in the same shares for $100. It is clear in this example that the short sale expense represents the cost of obtaining the use of the property sold short, and, more particularly, the cash proceeds of the short sale. As a result, the expense corresponds closely to interest, a characterization that is reflected in the interest and carrying charge provisions of section 263(g) of the Code.

Based on this analysis, we suggest that consideration be given to providing different treatment for short sale expenses, depending on the length of time the short sale is held open. If the short sale is held open for a brief period of time, say 6 months, we believe it would be appropriate to assume that the taxpayer has acquired a matured dividend right, so that the payment should not be deductible, but instead should be capitalized to the account of the short sale.

If the short sale is open for a longer period, such as in excess of 6 months, it may be appropriate to treat such payments as interest substitutes, consistent with the rule of section 263(g)(2)(A)(ii). Under this approach, the payments generally would be deductible, but the limitation on the deductibility of investment interest (section 163(d)) and the disallowance rule applicable to interest on indebtedness incurred to purchase or carry tax-exempt obligations (section 265(2)) should apply.

Recommendations Relating To The Taxation Of Foreign Corporations

Background

The tax regime imposed by the Code on foreign corporations differs from that imposed on domestic corporations. In general, the latter are subject to U.S. taxation on their worldwide income while the former are subject to U.S. taxation on a more limited basis. More specifically, foreign corporations are subject to U.S. taxation on a gross basis (without deductions) on fixed or determinable gains, profits and income (*e.g.*, dividends, interest, rents and royalties) from U.S. sources, and on a net basis (net of deductions) on income effectively connected with the conduct of a U.S. trade or business. Effectively connected income of a foreign corporation is taxed at a rate, and in a manner, comparable to that of a U.S. person.

The income of a foreign corporation not engaged in business in the United States therefore is not subject to current U.S. tax. A U.S. shareholder, however, is taxed on distributions received out of earnings of a foreign corporation. Certain categories of undistributed income of a foreign corporation which is controlled, directly or indirectly, by U.S. persons are not entitled to the general rules deferring taxation until receipt by a U.S. shareholder, and may be included currently in a U.S. shareholder's income under the subpart F, foreign personal holding company or foreign investment company anti-deferral rules of the Code.

A dividend paid to a 10 percent or greater U.S. corporate shareholder carries with it a "deemed paid" foreign tax credit for the foreign tax imposed on the accumulated profits from which the dividend is paid. Undistributed earnings included in the income of a U.S. corporate shareholder (and electing individual shareholders) of a controlled foreign corporation under subpart F also carry a deemed paid credit for foreign taxes paid on the earnings and profits from which the amount is considered to be paid. A previously taxed earnings and profits account also is created for the earnings of the controlled foreign corporation which have been taxed directly to U.S. corporate or individual shareholders.

General Discussion

The report contains three specific recommendations pertaining to the taxation of foreign corporations. I will describe these proposals in more detail below. It should be recognized, however, that the report's proposals could have far-reaching consequences on the present regime for taxing foreign corporations. I will discuss briefly only one of several possible examples.

As discussed earlier, one of the proposals is to repeal the earnings and profits limitation on dividend income. The report states that the earnings and profits concept would be retained for other purposes under the Code, and cites as examples the deemed paid foreign tax credit, the treatment of controlled foreign corporations and the recapture of untaxed earnings on the sale of stock of a controlled foreign corporation.

As described above, the income of a foreign corporation generally is not taxed until it is distributed, or deemed distributed, to a U.S. shareholder. In this connection, a vital linkage exists under present law between the distribution, or deemed distribution, and the earnings and profits from which the distribution is considered to be paid. The report does not specify how the proposal to repeal the earnings and profit limitation on dividend income would be integrated with the present regime for taxing foreign corporations. It is apparent, however, that severing the relationship between a dividend and the earnings and profits from which it is paid would require significant alterations to our present rules for taxing foreign corporations.

We believe that there is merit in being able to apply domestic corporate tax rules equally to foreign corporations. The alternative suggested by the report -- having separate rules for foreign corporations -- would frustrate the quest for simplification, one of the principal objectives of the proposals. In addition, we are concerned that such disparate tax treatment would make the tax laws less neutral with respect to a decision to conduct foreign operations through a branch of a domestic corporation or a foreign subsidiary. Further study would be necessary to ensure that such different tax treatment would not lead to unintended results. For these reasons, in addition to those set out above, we would prefer that the definition of earnings and profits be refined rather than repealed.

In general, we believe that the report's proposals need to be carefully analyzed to determine their impact on our system of taxing foreign corporations. These proposals would cause difficult transition problems in the foreign area if this relationship were not anticipated carefully.

Specific Recommendations Made by the Staff

Section 367. Section 367(a) is the principal mechanism in the Code designed to prevent the avoidance of Federal income taxes where assets carrying unrealized income potential are transferred outside the United States. Section 367(a) currently requires gain to be recognized when property is transferred by a U.S. person to a foreign corporation in certain exchanges that otherwise would be accorded nonrecognition treatment. Gain is recognized if the transfer is "pursuant to a plan having as one of its principal purposes the avoidance of Federal income taxes." Because the Tax Court has adopted a narrow interpretation of the "principal purpose" requirement, the IRS has had difficulty administering this provision in a way which restricts the types of tax avoidance transfers that section 367 was intended to combat. The report recommends that section 367(a) be amended and suggests as alternative approaches either (i) lowering the principal purpose threshold to a "significant" or a "material" purpose test, or (ii) substituting an "effects" test for the subjective purpose test. Under the latter approach, gain would always be recognized with respect to designated "tainted" assets.

The Treasury Department and IRS have been engaged in a review of section 367(a). We generally agree that it would be desirable to adopt some form of an "effects" test. As the report recognizes, however, certain assets such as manufacturing and marketing intangibles raise particularly complex issues, and the details of any such test therefore would require careful consideration. We are not prepared at this time to make a specific proposal, but would be pleased to work with the Committee to formulate an amendment.

Expansion of Section 1248. Under section 1248, gain recognized by certain U.S. shareholders on the sale or other disposition of stock of a controlled foreign corporation must be included in the shareholder's gross income as a dividend to the extent of the foreign corporation's previously untaxed, post-1962 earnings and profits which are attributable to the shareholder's stock during the period the shareholder owned that stock. Section 1248 recapture generally applies to any U.S. person who, during the five years preceding the sale, was a 10 percent or greater shareholder while the foreign corporation was a controlled foreign corporation.

The report recommends simply that "decontrol" of a foreign corporation trigger section 1248 recapture. The report does not specify how and to whom the recaptured income is to be taxed. It is not clear from the report that a U.S. shareholder owning less than 10 percent of the foreign corporation would not be subject to the recapture rule even though the shareholder would not be subject to section 1248 under present law. It also is not clear whether the recapture would occur at the time of decontrol or upon a later disposition of the stock.

The recommendation was made in response to a transaction involving particular circumstances in which section 1248 recapture was allegedly avoided. The recommended change to section 1248 has a sweep that extends far beyond the class of transactions which are apparently its target. We believe that the implications of this recommendation require additional study.

The report also recommends that two special deemed realization rules be adopted for purposes of section 1248. This proposal would cause the unrealized gain inherent in certain "collapsible" and "subpart F" assets held by a foreign corporation to be included for purposes of determining earnings and profits at the time of the section 1248 recapture event. The addition of the collapsibility provision is designed to offset the report's recommended repeal of the collapsible corporation rules of section 341 for domestic corporations. The addition of unrealized subpart F income to section 1248 earnings is based on a similar rationale. This recommendation, like the decontrol proposal, has not received extended consideration by Treasury or other interested parties, and we believe that it deserves further study.

Special Limitations on Net Operating Losses and Other Tax Attributes

Background

Under current law, a corporation that incurs a net operating loss in one year generally is permitted to use the loss to offset income earned in the three taxable years prior to and the fifteen taxable years after the year in which the loss is incurred. The underlying premise of allowing a corporation to offset a net operating loss incurred in one year against taxable income earned in another year is to provide an averaging device to ameliorate the unduly harsh consequences of a strict annual accounting system.

Section 382 was added to the Internal Revenue Code in 1954 to establish objective tests that would curb "trafficking" in corporations with unused net operating loss carryovers. Congress was particularly concerned that corporations were acquiring shell corporations whose principal asset was a net operating loss carryover that could be applied in future years against income unrelated to any business activity of the acquired corporation. If such trafficking in loss corporations were permitted, the underlying averaging function of the carryover provisions would be lost.

In addition to the specific objective limitations contained in section 382, the carryover of net operating losses may be disallowed under section 269 if the principal purpose of an acquisition of stock or assets is to secure the benefit of the net operating losses. Thus, section 269 is available to prevent misuse of the general carryover provisions. Moreover, special limitations, contained in Treasury Regulations, apply in certain instances to limit the use of net operating loss carryovers by consolidated groups of corporations.

In the Tax Reform Act of 1976 ("1976 Act"), Congress sought to strengthen the provisions of section 382 to deal with "trafficking" in loss corporations and to make those provisions more nearly uniform for taxable and tax-free acquisitions. The 1976 Act amendments were enacted in part because Congress believed that section 382 was ineffective and did not adequately serve its purpose. The effective dates of the 1976 Act amendments, however, have been delayed in response to criticism. The 1976 Act amendments are currently scheduled to become effective on January 1, 1984, in the case of tax-free reorganizations, and on June 30, 1984, in the case of taxable purchases.

Section 382, both as presently in effect and as modified by the 1976 Act, contains two sets of rules for limiting the utilization of net operating losses. One set of rules applies in cases of changes of stock ownership by purchase ("purchase rule") and the other set of rules applies to certain tax-free reorganizations ("merger rule"). Identical limitations are provided in section 383 on the use of other tax attributes -- such as investment tax credit carryovers, foreign tax credit carryovers, and capital loss carryovers -- following an acquisition. While, for convenience, this discussion will refer primarily to net operating loss carryovers, many of the same principles, also apply to these other items.

Purchase Rule

Under existing section 382, the carryover of net operating losses, in the case of taxable acquisitions, is denied entirely if (i) more than 50 percent of the stock of the corporation that incurred the loss ("loss corporation") changes ownership by purchase within two taxable years; and (ii) the loss corporation does not continue to carry on substantially the same trade or business after the change in stock ownership. Thus, in a transaction in which stock is purchased, the carryover of net operating losses is prohibited if there is both (i) insufficient "continuity of interest" by the loss corporation's shareholders; and (ii) insufficient "continuity of business enterprise" after the stock purchase. If, therefore, the purchaser of a loss corporation continues to carry on the trade or business previously conducted by the loss corporation, there is no limitation on the use of net operating losses.

The 1976 Act amendments removed the requirement that the historic trade or business of the loss corporation be terminated before limitations on carryovers would be imposed following a taxable acquisition. Under the 1976 Act amendments, net operating loss carryovers would be limited even if the new shareholders continued to conduct the same trade or business. Thus, the focus of section 382 was shifted solely to changes in stock ownership. The 1976 Act amendments also raised the threshold for application of the purchase rule from a 50 percent to a 60 percent change in stock ownership. This increase in the threshold was enacted to coordinate the rules applicable to purchases with those applicable to tax-free reorganizations. In addition, rather than eliminating all net operating losses once the required change in stock ownership has occurred, net operating loss carryovers under the 1976 Act are gradually phased out as the percentage change in stock ownership increases. This gradual reduction is identical in amount to the reduction provided in the case of tax-free reorganizations.

Merger Rule

Under section 382 as presently in effect, the carryover of net operating losses generally is limited in the case of certain tax-free reorganizations if the stock in the acquiring corporation received by shareholders of the loss corporation in the acquisition is less than 20 percent of the stock of the acquiring corporation. In such a case, the net operating loss carryovers of the loss corporation are gradually reduced based upon the level of the loss shareholders' ownership in the acquiring corporation.

Under the 1976 Act, the types of tax-free reorganizations to which section 382 applies were expanded significantly to prevent avoidance of the limitation. Moreover, the level of retained stock ownership at which net operating loss carryovers are first subject to limits was increased by the 1976 Act from 20 percent to 40 percent, with the net operating loss carryovers available to the acquiring corporation being phased out gradually as the loss corporation shareholders' percentage ownership in the surviving corporation declined below 40 percent.

Summary of Proposal

Unlike existing section 382 or the 1976 Act amendments, the proposal contained in the report does not reduce the amount of the net operating loss carryovers that can be utilized by an acquiring corporation. Rather, it seeks to limit the amount of income that may be offset by the loss carryovers to the income attributable to the pool of capital that generated the loss.

In general, the proposal attempts to permit the use of a loss corporation's net operating losses, following a taxable stock acquisition or a tax-free reorganizaton, to the same extent, as to both timing and amount, as would have been possible if ownership of the loss corporation had not changed and the corporation had invested its assets in activities generating taxable income. The proposal, like existing law and the 1976 Act amendments, includes two sets of rules, one applying primarily to cases in which the stock of the loss corporation is acquired in a taxable purchase and a second applying to cases in which the stock or assets of a loss corporation are acquired in certain tax-free reorganizations.

Discussion

Before discussing the proposal in greater detail, it is useful to outline briefly the theoretical underpinnings of limitations on the carryover of net operating losses and other tax attributes following the acquisition of a corporation. It also is useful to describe generally the criticism of existing law and the 1976 Act amendments.

In analyzing the issues raised by the carryover of corporate net operating losses, commentators have suggested the following competing, and somewhat inconsistent, tax and economic policy considerations:

- Any rule governing the carryover of tax attributes should be consistent with the historic legislative intention that the carryover provisions serve as income averaging devices;

- The tax laws should not unduly distort investment decisions and should not create undue bias between diversified and non-diversified entities or between old and new businesses;
- A corporation's ability to carry over net operating losses should not require the Federal government to be a partner in all businesses (i.e., the rules governing the use of net operating losses should not amount to a Federal subsidy for all such losses);
- The rules applicable to the carryover of net operating losses should prevent "trafficking" in loss corporations;
- Any limitations on the carryover of net operating losses and other tax attributes, to the extent possible, should not result in tax attributes of a corporation becoming more or less valuable in the hands of a purchaser of the corporation than they would have been in the hands of the seller;
- The tax laws should not encourage corporate acquisitions that would not be undertaken for non-tax reasons; and
- The rules establishing limitations on carryovers should provide certainty in determining the extent to which tax attributes will survive an acquisition so as to prevent a purchaser from obtaining a windfall from the carryover.

As is apparent from these principles, the initial question that must be faced is whether any limitations should be imposed on the use of net operating loss carryovers. One can argue that the rules governing the use of net operating loss carryovers will not create a bias among various types of entities and businesses and will not distort investment decisions only if all limitations are removed from the utilization of net operating loss carryovers. The furthest move in this direction would be to provide for refundability of net operating losses. In a refundability system, a corporation that incurred a net operating loss would receive a refund from the Federal government equal to the tax savings that would have resulted if the corporation had been able to offset fully the net operating loss in the current year against other income.

A provision for direct reimbursement of net operating losses by the Federal government would, of course, eliminate trafficking in corporations that had unused net operating losses, one of the perceived abuses section 382 is designed to prevent. Moreover, such a system would ensure that the benefits of a net operating loss would accrue directly to the entity that suffered the loss and would eliminate the current bias in favor of conglomeration that exists with respect to the deductibility of net operating losses. This bias exists because net operating losses of one business may be offset against profits of another business, thereby reducing the conglomerate's current tax burden. By comparison, a corporation engaged in a single line of business does not receive any tax benefit from a net operating loss until and unless that corporation realizes offsetting income. On a present value basis, such a net operating loss is worth less than a net operating loss that is usable currently. A reimbursement system would eliminate this bias by providing the same after-tax consequences for a net operating loss regardless of the existence of a related profitable enterprise.

Similarly, the current treatment of net operating losses is biased in favor of established enterprises, with respect to undertaking new investments. An established corporation that incurs a loss in starting a new line of business may secure an immediate refund under current law by applying that loss against past taxable profits. A new corporation, by contrast, is unable to utilize a net operating loss until it realizes taxable income. A system of refundability also would eliminate this bias by equalizing the treatment between new and existing businesses in the event of a loss.

While a system of refundability might well make the net operating loss provisions more neutral among various types of enterprises, we do not believe it is advisable to implement such a proposal. A system of refundability would require the Federal government to become a partner in all investments, a role we believe is inappropriate. Moreover, a system of refundability would pose potentially insurmountable administrative and budgetary problems. For example, verification of the bona fide value of the net operating losses would be imperative, yet extremely difficult, complex and, perhaps, impossible.

Short of providing direct government reimbursement of net operating losses, it can be argued that all limitations on the carryover of tax attributes from one corporation to another, such as section 382, should be repealed. While the resulting system, which can be described as free trafficking in corporations with favorable tax attributes, would not achieve complete neutrality, it would ensure that most of the benefit of the net operating losses would be realized by those who suffered the economic losses. Consequently, purchasers of loss corporations would not be able to realize windfall profits at the expense of loss corporations or their shareholders.

The arguments in favor of unrestricted trafficking in loss corporations (and the arguments in favor of refundability) go far beyond the legislative intention to provide an averaging device to reduce the inequity of a strict annual accounting system. In essence, unrestricted trafficking in loss corporations may be considered a less efficient form of refundability. As stated above, we do not believe that the carryover rules were intended to serve the function of providing Federal subsidies, whether direct or indirect, for corporate losses.

Although we recognize that both refundability and the unrestricted trafficking in loss corporations might make risk-taking in corporate form more attractive, it is not clear that risk-taking is relatively discouraged under existing tax rules. Moreover, the unrestricted ability to use corporate tax attributes, including net operating loss carryovers, would encourage the takeover of loss corporations by profitable ones primarily to obtain the tax benefits of net operating loss carryovers. Such tax-motivated mergers and acquisitions may have adverse effects on the economy and should not be encouraged.

Alternate Bases For Limitations

Accepting, as we do, that the transferability of unused net operating loss carryovers should be limited, it is necessary to examine the various bases upon which such a limitation may be imposed. The bases for limiting net operating loss carryovers that have been used in the past are continuity of shareholder interest and continuity of business enterprise.

For purposes of section 382, continuity of shareholder interest may be defined as the continued economic interest of the shareholders of the loss corporation in that corporation or its successor during the taxable years subsequent to the years in which the net operating losses were incurred. Since its enactment in 1954, section 382 has considered continuity of shareholder interest a significant factor in determining whether, and the extent to which, the carryover of net operating losses should be limited. Moreover, the 1976 Act amendments to section 382 established continuity of shareholder interest as the sole factor to be considered in determining the limitation on net operating loss carryovers following a change in ownership of the loss corporation.

The rationale for using continuity of shareholder interest as the basis for limiting carryovers is that a corporation's shareholders generally are the real parties who suffer economic loss when the corporation they own incurs a net operating loss. The loss carryover thus should be deductible by the corporation only if such a deduction will reduce the economic loss incurred by those shareholders.

We believe that reliance on continuity of shareholder interest as a determinative factor for limiting carryovers, particularly as the sole factor as set forth in the 1976 Act amendments, is subject to serious criticism. First, a limitation based on continuity of shareholder interest may be inconsistent with the income averaging function of the net operating loss carryover provision. For example, net operating losses frequently result from a corporation's ability to deduct expenses prior to the year in which corresponding items of income must be reported. This mismatching of income and expenses frequently occurs in the case of assets that are subject to the Accelerated Cost Recovery System. To the extent that net operating losses result from this mismatching of expenses and income, the lack of continuity of shareholder interest should not limit the ability of the business to use its net operating losses to offset income realized in subsequent taxable years.

Second, a limitation based on a specified percentage of continued shareholder interest may create undesirable economic effects. For example, if shareholders of the loss corporation are required to own a minimum percentage of the stock of the surviving corporation, a relatively large corporation, because it would be denied the use of otherwise available net operating loss carryovers, might be motivated to pay less for a smaller loss corporation than would a smaller potential purchaser. Certain acquisitions might thus be discouraged even though desirable without regard to tax considerations. We believe economically motivated acquisitions should not be unduly penalized by the tax laws.

The second factor upon which the limitation on the carryover of net operating losses has been based is continuity of business enterprise. Under the continuity of business enterprise test, limitations are imposed on the carryover of net operating losses if the business conducted by the loss corporation is not continued by the acquiring corporation.

The continuity of business enterprise doctrine, as a test to determine the availability of net operating loss carryovers, suffers several serious flaws. First, the continuity of business enterprise test is difficult to apply whenever significant new capital or other assets are added to the old business, or where the old business is operated in a different manner. This uncertainty has resulted in costly and time-consuming litigation, without clarifying the ambiguous nature of the standard. Such uncertainty causes purchasers to reduce the price they offer for loss corporations and gives the purchasers an opportunity to realize a windfall profit at the expense of the loss corporation and its shareholders. Thus, the intended beneficiaries of the provision do not properly benefit from the carryover of the net operating losses by the acquiring corporation.

Second, using continuity of business enterprise as a means to limit the utilization of net operating loss carryovers may encourage a loss corporation, or a corporation that purchases the loss corporation, to continue operating an unprofitable business. Such uneconomic behavior should not be encouraged by the tax laws.

Third, even if the continuity of business enterprise test is met, the continuing business may be an insignificant part of the surviving corporation, or may produce no income, yet the net operating losses incurred prior to an acquisition can be used in full against other income of the acquiring corporation. Such a result, which in the extreme will be tantamount to free transferability of net operating losses, may be unsatisfactory.

The existing rules of section 382, which rely on both continuity of business enterprise and continuity of shareholder interest, suffer the same defects as their theoretical underpinnings. Moreover, we believe that existing law is deficient because many corporate acquisitions can be structured to avoid the application of the section 382 limitations in situations in which there may be no substantial business purpose other than utilization of the net operating loss carryovers of the acquired corporation. While section 269 can be used to curtail such acquisitions, existing section 382 inadequately serves its purpose when its provisions can be so easily avoided.

The 1976 Act, in an attempt to create a more effective set of rules, eliminated the continuity of business enterprise requirement, coordinated the treatment of acquisitions by purchase and tax-free reorganization, and tightened the rules to prevent avoidance. The rules enacted in 1976, however, have been criticized for their complexity. While complexity in the tax laws should be avoided whenever possible, it is justified if the rules are necessary, theoretically correct, and effective. We believe, however, for the reasons stated above, that reliance solely on continuity of shareholder interest is neither necessary nor theoretically correct. Thus, we believe that alternative methods of limiting the utilization of net operating loss carryovers should be explored.

One alternative that has been suggested, which has enjoyed widespread support, is the so-called pool of capital approach. The basic principle of this approach, which is the theoretical basis of the proposal being considered by the Committee, is that the entire net operating loss carryover is preserved after a loss corporation is acquired, but a limit is imposed on the amount of annual earnings against which the net operating loss carryovers can be offset. The limit in general is based on the presumed income stream from the assets owned by the loss corporation at the time it generated the net operating losses.

Detailed Analysis of the Proposal

The proposal, like existing law and the 1976 Act amendments, involves two sets of rules, one for purchase transactions and a second for certain tax-free reorganizations. The mechanics of the proposal, however, are quite different from existing law or the 1976 Act amendments.

Purchase Rule

The purchase rule provides in general that net operating loss carryovers of the loss corporation will be limited, as to both timing and amount, to the income the loss corporation would have earned had no change of ownership occurred and had the loss corporation begun to earn taxable income at an assumed rate of return on the assets it owned at the time the loss was generated. This rule will apply whenever the ownership of the outstanding stock of a corporation changes hands in a taxable purchase after a year in which the corporation incurred a loss. In addition, the purchase rule would apply to any tax-free reorganization, to the extent that the consideration used by the acquiror was neither stock of the acquiror nor stock of a corporation that controlled the acquiror.

Under the proposal, no limitations on net operating loss carryovers would be imposed unless more than 50 percent of the outstanding stock changed ownership after a loss year. In determining whether changes in the corporation's ownership were sufficient to invoke the rule, only shareholders who owned five percent or more of such stock in the carryover year, directly or by attribution, would be considered. Moreover, a shareholder in the loss year could increase his percentage interest by 50 percent without the purchase rule applying to that transaction. The change in such shareholder's interest, however, would be considered for purposes of determining whether more than 50 percent of the stock had been sold or exchanged.

If 100 percent of the stock of a corporation were purchased, the purchase rule would limit the deduction of net operating loss carryovers for each subsequent taxable year to an amount equal to an assumed rate of return times the purchase price of the stock. The proposal specifies that the assumed rate of return would be an after-tax rate to reflect the fact that, because the post-acquisition profits of the loss corporation would not have been subject to tax to the extent offset by the net operating loss carryovers, the consideration paid for the stock would be based on the pre-tax and after-tax rate of return on the loss corporation's assets being the same. The proposal suggests that the assumed rate of return might be some percentage, such as 125 percent, of the fluctuating interest rate determined semi-annually pursuant to section 6621.

If more than 50 percent but less than 100 percent of the loss corporation's stock were purchased, the portion of the acquiring corporation's income attributable to the stock that had not been sold could absorb net operating loss carryover deductions without limitation. The remaining portion of the earnings, attributable to the stock that had been purchased, could be offset only in an amount equal to the assumed return on the purchase price of that stock.

In addition to applying to changes resulting from sales or exchanges of stock, the purchase rule also would apply in the case of redemption, by treating increases in the percentage of stock owned by the loss year shareholders, caused by a redemption, as if those shareholders had purchased stock for its fair market value after the redemption. If the ownership of stock changed as a result of a combination of purchases and redemptions, the amount of the limitation provided by the purchase rule would be determined by treating redemptions as if they occurred prior to purchases.

We support the theory underlying the proposed purchase rule; however, we believe it entails some practical problems. Because the proposal contemplates that the assumed rate of return used in the calculation of the limitation will vary semi-annually after the transaction, potential sellers and purchasers of loss corporation stock would be forced to predict future fluctuations in the rate of return to determine the economic benefit inherent in the tax attribute, thereby making quite difficult the date-of-sale market valuation of the stock of the loss corporation. We believe that such uncertainty, like the uncertainty present in existing law regarding the continuity of business enterprise test, generally will benefit the purchasers of loss corporation stock, who will insist on discounting the value of net operating loss carryovers. Thus, the corporation and shareholders that suffered the economic loss will not benefit fully from the potential net operating loss deductions, and the acquiring corporation will realize an unjustified profit.

Even if the rate of return did not fluctuate periodically, the use of specified assumed return raises difficult issues. Perhaps most importantly, the assumed rate of return would necessarily be an arbitrarily determined one. Accordingly, its use would be inappropriate in many instances. Moreover, the choice of the assumed rate would be extremely difficult. For example, the proposal states that the rate of return should be an after-tax rate, and might be a function of the interest rate provided in section 6621. The interest rate provided in section 6621 is the average predominant prime rate quoted by commercial banks to large businesses. Because commercial banks are taxable entities, the interest rate charged to their customers represents a pre-tax return. While such a rate might nevertheless be a reasonable estimate of after-tax return on equity investments in certain instances, this is by no means certain.

While not suggested in the proposal, it is possible that the goals of the purchase rule might be realized, while avoiding some of the problems raised by a rate of return, by using an approximation of the actual rate of return assumed by the parties in lieu of a statutorily specified return on net assets. Such an alternative formulation of the purchase rule might limit the net operating loss carryovers of the loss corporation that could be used annually by the acquiring corporation to an amount equal to the purchase price of the loss corporation's stock, perhaps after applying an appropriate discount rate, amortized over an appropriate period. We recognize that selection of both the appropriate discount rate, if any, and the appropriate amortization period raises some of the problems referred to with respect to the determination of the rate of return. However, we believe that the Committee should consider such a revision in the purchase rule.

In addition to the practical problems raised by the purchase rule set forth in the proposal, we are concerned that the interplay of the many technical provisions might permit avoidance of the rule's intent. We believe, therefore, that care must be taken to ensure that manipulation of the purchase rule does not enable avoidance of the limitations on the carryover of corporate tax attributes. We would be pleased to work with the Committee in formulating protective rules that would eliminate such possibilities.

Merger Rule

Under the proposal, a separate set of rules applies to any case in which the stock or assets of a loss corporation are acquired in a tax-free reorganization, for stock of the acquiring corporation, or for stock of a corporation that controls the acquiring corporation. Under the merger rule, the net operating loss carryovers otherwise available would be allowed to offset only the portion of income, earned by the surviving corporation after the acquisition, that is allocable to the contribution of the loss corporation's assets to the acquiring corporation. This merger rule is intended in principle to permit the use of net operating loss carryovers to the same extent that such carryovers would have been allowed if the loss corporation and the acquiring corporation had contributed all of their assets to a joint venture. The proposal attempts to duplicate the fact that, under such circumstances, only the portion of the joint venture's income allocable to the loss corporation could be offset by that corporation's net operating loss carryovers.

After a tax-free reorganization to which the merger rule applies, the portion of the post-acquisition taxable income of the surviving corporation and its subsidiaries allocable to the loss corporation's assets would be determined by reference to the percentage of common stock of the acquiring corporation issued in the acquisition to the loss corporation's shareholders. The percentage of the acquiring corporation's taxable income that could be offset, however, would be less than the percentage of stock of the acquiring corporation issued to the loss year shareholders in the acquisition. The reduction is necessary because post-reorganization taxable income theoretically allocable to the loss corporation would not be subject to tax to the extent of allowable net operating loss carryovers. As a result, the percentage of the acquiring corporation's participating stock that would be issued in the acquisition generally would exceed the percentage of taxable income of the acquiring corporation allocable to the loss corporation's assets that generated the net operating loss.

The percentage of income that could be offset would be set forth in a statutory table keyed to the percentage of the participating stock of the acquiring corporation issued to the loss shareholders in the acqusition. For example, if the acquiring corporation issued 50 percent of its participating stock to the loss shareholders, then 35 percent of the post-acquisition income could be offset by the loss corporation's net operating loss carryovers.

If an acquiring corporation issued stock and paid other consideration in a tax-free reorganization, the proposal contemplates that both the purchase rule and the merger rule would apply. Thus, the surviving corporation would be able to utilize net operating loss carryovers in an amount equal to the sum of (i) the value of the other consideration times the applicable rate of return plus (ii) the portion of the surviving corporation's income that is allocable to the stock issued to the loss corporation shareholders.

If the acquiring corporation issued to loss shareholders only preferred stock with a "market rate" yield, the net operating loss carryovers otherwise available would be allowed only to the extent of dividends paid or accrued on the preferred stock issued in the acquisition. The proposal states that special rules would be applied to cases in which the acquiring corporation had preferred stock outstanding at the time of the acquisition and to situations in which hybrid or convertible securities, options, warrants and the like were issued to loss shareholders in an acquisition. The proposal does not indicate the scope or the anticipated complexity of these special rules. We believe, as described further below, that the complexity of such rules may suggest adoption of a single rule applicable to all acquisitions of loss corporations.

Although we believe that the merger rule might work well when only common stock or preferred stock with a determinable rate of return is outstanding after a reorganization, application of the merger rule may be unworkable in cases in which more complicated types of securities are involved. Thus, while the merger rule may be sound in concept, we question whether it could be applied effectively to reorganizations other than relatively simple ones. In light of such narrow applicability, we question whether the additional complexity created by the existence of two sets of rules is warranted. Moreover, the existence of two sets of rules creates the potential for inconsistent treatment of similar transactions and may permit transactions to be structured to avoid certain limitations. For these reasons, it may be desirable to apply the purchase rule to all acquisitions of loss corporations. We recognize that application of the purchase rule would require the difficult task of valuing stock received in a tax-free reorganization; however, such valuation may in any event be required under the special rules applicable to hybrid securities and the like.

New Stock Issues

The proposal provides no limitation on the use of net operating loss carryovers if new stock is issued for cash or property by a loss corporation *pro rata* to shareholders who owned stock during the year in which the net operating loss was incurred. Moreover, no limitation would apply if such shareholders increased their interest in the fair market value of the loss corporation's stock by 50 percent or less. We recognize that imposing no limitations on net operating loss carryovers in these situations may be appropriate when no other events trigger application of any limitations on the use of net operating loss carryovers. We believe, however, that substantial difficulties may arise in applying this rule after a trigger event has occurred and a limitation on the use of carryovers is otherwise applicable.

If a loss corporation issued new stock to third parties, the merger rule would apply to limit subsequent use of the net operating losses based on the percentage interest in the loss corporation's common stock remaining with loss year shareholders. Similarly, if a loss corporation issued new preferred stock to third parties, the proposal would decrease the income that could be offset by otherwise available net operating losses by the total yield on such newly-issued preferred stock, increased to reflect the corporate tax paid on the earnings used to pay this amount.

This new issue limitation would not apply, however, in any case in which the loss corporation issued to third parties in any one calendar year new shares, common or preferred, having a value of less than 20 percent of the value of the loss corporation's shares outstanding at the beginning of the year. If the 20 percent floor were exceeded in any year, the new issue limitation would be applied to the entire issue, not merely the excess over 20 percent.

Although limiting subsequent use of net operating loss carryovers in cases in which contributions are made to the capital of the loss corporation by third parties is consistent with the underlying theory of the pool of capital approach, the threshold change at which such a provision applies should be studied carefully prior to enactment. An unduly low threshold might discourage attempts to rehabilitate loss corporations, a pressure we believe should be avoided. Moreover, such a rule would seem to encourage loss corporations to borrow capital, rather than to seek new equity capital. Such a bias in favor of debt undoubtedly would put added pressure on the tax rules provided to distinguish debt from equity.

Investment Companies with Net Operating Loss Carryovers

An important issue that must be confronted when formulating limitations on the utilization of net operating loss carryovers is whether a loss corporation which has converted operating assets to passive investment assets should be able to retain net operating losses incurred with respect to the operating assets. The proposal contemplates that, in order to prevent tax-motivated acquisitions of loss corporations without significant business assets, no carryover of net operating losses should be permitted following a change in ownership of a corporation, substantially all the assets of which were investment assets at the time of acquisition.

We believe that, in theory, a corporation owning only investment assets generally should be able to retain and transfer its net operating loss carryovers to the same extent as a corporation that owns primarily operating assets, so long as the rules relating to contributions to capital and new stock issues prevent avoidance of the applicable limitations. In the context of the pool of capital approach, it is difficult to distinguish between a loss corporation that continues to own its operating assets and one that has converted those assets to passive investment assets. Moreover, it would be difficult to define the term investment assets in many industries, including banking, insurance and securities. Finally, applying special rules to corporations that convert operating assets into investment assets would have the undesirable effect of encouraging loss corporations to retain unprofitable businesses rather than convert them into more liquid investments.

The unlimited ability to sell a corporation the assets of which include only investment assets and net operating loss carryovers, however, might be perceived as being abusive and thus might affect the public's view of the tax system. We recognize, moreover, that the ability to convert business assets into investment assets prior to a purchase or reorganization might in some instances permit transactions that would avoid the applicable limitations. Accordingly, if such corporations are allowed to transfer net operating loss carryovers, we believe that safeguards would be necessary to prevent abuse of the rules.

Stock Issued to Creditors

Under the proposal, creditors who exchange debt for stock would be treated as purchasers of already outstanding shares of stock for a price equal to the amount of debt extinguished.

Therefore, the net operating loss carryovers that could be utilized following such an exchange would be limited to that portion of the corporation's income equal to the rate of return times the amount of debt extinguished. Any stock received for debt that was held by persons who became creditors after a loss year, however, would be treated the same as any other issuance of shares.

The special rules applicable to creditors reflect the fact that such persons frequently are the parties who economically bear the losses that are reflected in net operating loss carryovers. Although we recognize the special status of such creditors, we believe that the legitimate interests of creditors must be carefully balanced against the possibility that the special rules could be used to avoid the applicable limitations. We would like to work with the Committee to ensure that the special creditor rules cannot be abused.

Built-in Gains and Losses

The proposal would increase the extent to which net operating losses could be utilized in a taxable year following a change in ownership of the loss corporation by the amount of built-in gains existing at the time of the ownership change and realized during the year. The proposal also contemplates that any built-in losses would reduce the amount of built-in gain that would increase the available net operating loss carryovers.

Although it may be consistent with the theory of the pool of capital approach to adjust the applicable limitation on the use of net operating losses to reflect the net built-in gain existing at the time the ownership of the loss corporation changes hands, we believe that, prior to enactment, careful consideration should be given to any provision that would increase the applicable limitation by the amount of built-in gain. Moreover, even if such a provision were determined to be appropriate, several limiting principles would be necessary. For example, application of this built-in gain provision might in some instances result in an artifically high limit on the use of net operating loss carryovers. Unfortunately, an attempt to provide the adjustments necessary to avoid such artifically high limits might result in unacceptable complexity. In addition, the attempt to determine the amount of built-in gain existing at the time of an acquisition and realized at a later date would be fraught with administrative difficulties and would result in complex valuation problems. Finally, it also should be recognized that although the amount of built-in gain realized during the year of the ownership change would have to be reduced by any built-in losses existing at the time of the acquisition, as reflected in the proposal, the built-in losses would be relevant for such a purpose whether or not those losses are realized during the year. The determination of the amount of such losses would, of course, be administratively difficult and quite complex.

Finally, the proposal contemplates that the amount of net built-in losses would be limited by regulations to the extent necessary to preclude avoidance of the pool of capital principle. The problems raised by built-in losses are complex and require careful study. A persuasive argument can be made, however, that built-in losses existing at the time that ownership of the corporation changes hands should be limited in the same manner as net operating loss carryovers. We would be pleased to work with the Committee in studying the difficult issues raised by built-in gains and losses.

Acquisitions by Loss Corporations

The proposal provides that the merger rule would apply to acquisitions by loss corporations in exchange for loss corporation stock, if the loss year shareholders own less than 80 percent in value of the loss corporation stock in the carryover year. This rule, which places some limits on the ability of a corporation with net operating loss carryovers to acquire other corporations that might produce taxable income against which the net operating losses can be offset, is similar to the provision in the proposal that limits a loss corporation's ability to issue new stock to third parties. In the case of new stock issues, no limitation applies if the loss corporation issues in any calendar year new stock worth less than 20 percent of the loss corporation's shares at the beginning of the year. In the case of an acquisition by the loss corporation, however, the 20 percent threshold, rather than being determined annually, is cumulative.

A loss corporation that intended to acquire other corporations would often do so by issuing new stock in any such transactions. Accordingly, we believe that the limitations on new share issuance should be parallel to the limitations on stock acquisitions and that the considerations referred to with respect to new stock issues should apply with equal force to acquisitions by loss corporations. We would be happy to work with the Committee in studying the issue and developing appropriate limitations.

Tax Classification of Partnerships with Publicly Traded Interests

The Staff would classify any limited partnership with interests traded on an established securities market as an association taxable as a corporation (the "classification proposal"). The report states in rather conclusory fashion that large, centralized business organizations ought to be subject to an entity level tax because of the similarity of these organizations to large corporations. In addition, the Staff expresses doubt about the adaptability of the partnership tax rules to the complexity presented by publicly traded limited partnerships. An unstated concern of the Staff may be that adoption of the other significant proposals in the report would increase the disparity between the taxation of partnership and corporate profits and thereby provide incentives for conducting in partnership form many activities presently conducted by corporations. The Treasury Department opposes the classification proposal.

Our principal objection to the classification proposal is that the classification of business organizations for tax purposes is a matter which involves tax policy considerations beyond the scope of this project. The proper classification and methodology for taxing publicly held limited partnerships are difficult questions which we think should be answered only after a thorough review of the taxation of all similar business organizations, including real estate investment trusts. We have serious doubt that after such an analysis one would conclude that the degree of marketability of an organization's equity interests should determine the manner in which the organization is taxed. We also are not convinced that access to a rational system of pass-through taxation should be restricted on the basis suggested by the classification proposal. As pointed out earlier in this statement, we are not prepared at this time to support proposals which significantly broaden the two-tier tax system of taxing corporate profits.

We also have some concern about the impact of the classification proposal on certain activities. The absence of an entity level tax appears to be a major factor in stimulating partnership capital formation. Many of the entities that would be affected by the classification proposal would be those which are seeking capital for natural resource exploration, research and experimentation and housing development. Any proposal that might reduce significantly the flow of capital into these ventures must be considered carefully.

The American Law Institute Federal Income Tax Project Tentative Draft No. 7 (1979), which is cited as support for the classification proposal, recommended as a general rule that unrestricted access to partnership status be permitted. Its suggestion to exclude publicly traded partnerships from this recommendation was based primarily on the perceived problems that the IRS would encounter in auditing these partnerships. We believe that many of these problems have been eliminated or substantially reduced as a result of the partnership level audit provisions contained in TEFRA. The administrative problem most often associated with publicly traded limited partnerships is the perceived difficulty in allocating various tax items among partners when there are multiple transfers of partnership interests during the taxable year or where partnership interests are held in street name. These allocation problems are faced to a greater or lesser degree by every partnership and we are not convinced that the mechanics of making these calculations are insuperable; nor are we aware of any significant abuses that have been linked to publicly traded limited partnerships. Indeed, we suspect that the reporting requirements imposed upon publicly traded and registered partnerships and the public scrutiny that these organizations receive make them less likely to engage in abusive activities than partnerships with fewer partners.

We also believe that the concern over a migration of corporations into partnership form is overstated. To date there has been no such large-scale movement notwithstanding that corporate earnings are subject to a more onerous tax regime. Such a move involves many considerations in addition to the Federal tax burden, including increased reporting and record-keeping requirements, and the uncertainties and state-to-state inconsistencies relating to the substantive law of partnerships.

For these reasons we must urge that the classification proposal not be adopted.

Finally, I would like to commend the Staff for its work to date. We look forward to working with the Committee and Staff on a continuing reevaluation of the corporate tax provisions of present law.

I would be pleased to answer any questions you may have.

The **Chairman**. I appreciate your testimony and your willingness to abbreviate it. Your entire statement will be made a part of the record.

We do have a number of questions, obviously, for the Treasury, but I would rather submit those in writing, because we have some witnesses who have been delayed because of my being delayed. Since you are right here where we can reach you rather quickly, we will move on to the next panel.

Mr. **Pearlman**. Thank you.

The **Chairman**. Unless you have another commitment, you may wish to remain. I don't want to trap you here, but if you would like to stay for a while, it might be helpful.

[Laughter.]

The **Chairman**. Thank you.

We now have a panel consisting of William D. Andrews, professor of law, Harvard Law School; Edward N. Delaney, chairman, section of taxation, American Bar Association, accompanied by John B. Jones, Jr., Covington & Burling, Washington, D.C.; Willard B. Taylor of Sullivan & Cromwell, New York, N.Y., and Herbert L. Camp, Donovan Leisure Newton & Irvine, New York, on behalf of the New York State Bar Association; and Frank V. Battle, chairman, Federal taxation committee, subchapter C project, Chicago Bar Association, Chicago, Ill.

While you are all getting seated, I will excuse myself for just a minute. I will be right back.

[Whereupon, there was a brief recess.]

The **Chairman**. We may proceed in any way you wish. Your entire statements will be made a part of the record, and if you can highlight your statement it would be helpful.

Do you want to start with Mr. Andrews?

STATEMENT OF WILLIAM D. ANDREWS, ESQ., PROFESSOR OF LAW, HARVARD LAW SCHOOL, CAMBRIDGE, MASS.

Mr. **Andrews**. Mr. Chairman, my name is William Andrews. I am a teacher of law at Harvard Law School, and I have been the reporter of the American Law Institute, subchapter C tax revision study over the past 8 years.

The institute has no procedure for responding to the staff proposals, and so I don't speak on behalf of the institute; but I speak on my own on the basis of extended involvement in the formulation of the ALI proposals.

The first and most important thing I want to say is to express enthusiastic support for the committee staff's proposals revising the general treatment of acquisition transactions, and to say that in general the staff proposals parallel those of the institute in their main themes. And I think the two documents should be regarded as supporting one another in that important respect.

There are differences in detail, which I think tend to affirm that the main themes have been put to the test by both groups independently, and that those deserve the committee's support at this time.

The main themes, just to mention them, are: The elimination of the reorganization definition and its replacement by a scheme of elective classification at the corporate level, together with an independent assessment of stockholder tax consequences and the elimination of the general utilities rule. Both of those two themes I think present the committee with the opportunity for enormous simplification in the overall tax treatment of acquisition transactions.

I guess I will rest otherwise upon my written statement.

The CHAIRMAN. What we had hoped to do is perhaps to come back with some questions that you may wish to address.

Mr. Delaney?

[Mr. Andrews' prepared statement follows:]

STATEMENT BY WILLIAM D. ANDREWS

before the

COMMITTEE ON FINANCE
UNITED STATES SENATE

with respect to

THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS

OCTOBER 24, 1983

Mr. Chairman and Members of the Committee:

My name is William D. Andrews. I am a Professor of Law at Harvard University where I have specialized in Federal Income Taxation, and particularly the income tax treatment of corporations and shareholders, for twenty years. I have also served as the General Reporter for Subchapter C in the American Law Institute's Federal Income Tax Project, from 1974 to 1982. While both these employments are quite relevant to the subject of this hearing, my appearance today is solely on my own and not on behalf of either the Harvard Law School or the American Law Institute.

The American Law Institute (ALI) has adopted proposals for revision of the statutes governing the tax treatment of corporate acquisitions and dispositions and has published a lengthy report, in May, 1982, explaining, illustrating and commenting upon those proposals and the problems to which they are addressed. American Law Institute, Federal Income Tax Project, Subchapter C, Proposals on Corporate Acquisitions and Dispositions, and Reporter's Study on Distributions, May 1982. As Reporter for that project I was deeply involved in the formulation of those proposals and was chiefly responsible for preparation of the report. I do not represent the ALI in my appearance today because the ALI has no procedure for taking positions on tax legislation beyond the publication of its own proposals, but my opinions are informed by lengthy immersion in the ALI work.

In its current study of corporate taxation the Committee Staff was directed to examine the ALI proposals, among others, and has done so with great care and understanding. Some of the Staff's proposals are indeed in close agreement with those of the ALI, and others are closely related in purpose and effect if not in detail. Still others fall on ground not covered in the ALI proposals. I would like mainly to talk about the relation between the ALI proposals and the related Committee Staff proposals, and then to talk briefly about two of the other Staff proposals.

The General Tax Treatment of Corporate Acquistions

Both the Committee Staff and ALI proposals call for rather fundamental revisions in our thinking about the taxation of corporate acquisitions. The two sets of proposals differ in detail, but the important thing about them is that they affirm common general themes. I would like to emphasize two.

1. Elimination of the distinction between reorganization and nonreorganization acquisitions. Current tax law applicable to corporate acquisitions is dominated by a categorical distinction between reorganization and nonreorganization transactions, reorganizations being governed, at both corporate and shareholder levels, by a whole separate set of rules that have no application to nonreorganization acquisitions. The operative rules governing reorganization acquisitions are themselves quite sensible, but the reorganization definition, on which their application depends, is senselessly complicated. The definition is partly statutory, containing quite different technical requirements for different forms of acquisition transactions - stock exchanges, informal asset acquisitions, statutory mergers, subsidiary acquisitions, reverse subsidiary acquisitions, and so on. Spread over all these disparate statutory requirements are some extrastatutory prerequisites set forth in judicial decisions and regulations, some of which seem to proceed from and foster an erroneous impression that reorganization characterization and treatment are a departure from some norm, to be permitted only on a strictly guarded basis.

Both Staff and ALI proposals would clear away this morass by eliminating the distinction between reorganization and purchase acquisitions as a controlling categorical dichotomy. Many of the operative rules governing the taxation of corporations in reorganizations would be preserved, but their application would be controlled by explicit elections, rather than compliance with the reorganization definition. This elective procedure is essentially the procedure already adopted by the Congress last year for purchased subsidiaries, in section 338. The Staff and ALI proposals would extend this procedure to replace the reorganization rules as well as old section 334(b)(2). Similarly, nonrecognition treatment of shareholders, as in a reorganization, would be preserved - but on the basis of a simple appraisal for each shareholder of the effect of the acquisition on his investment viewed alone.

This proposal does not involve substantial changes in what is permitted in the way of tax treatment of an acquisition, but it would produce enormous simplification and clarification in how it is to be done. It would further operate to decouple questions of corporate procedure from tax treatment so that taxpayers would be spared the unproductive necessity of shaping corporate transactions in possibly inconvenient forms to produce a chosen tax result. Putting choices of tax treatment on an explicitly elective basis would also reduce the chance for parties to a transaction to defeat the revenue by taking mutually inconsistent positions, relying on different interpretations of obscure aspects of the reorganization definition, as sometimes occurs under existing law.

2. Reversal of the General Utilities Rule. In General Utilities and Operating Company v. Helvering, 296 U.S. 200 (1935), the Supreme Court affirmed the notion that a corpor-

ation does not realize gain on the distribution of appreciated property to its shareholders. General Utilities involved a dividend distribution of shares of another corporation, but the rule has been applied also to distributions in liquidation or in redemption of shares. In 1954, the rule was codified and extended to cover corporate sales of assets, if made after adoption of a plan of liquidation. Sections 311, 336, 337.

The reasons for the General Utilities rule are obscure; the Supreme Court itself simply took the general rule for granted without explanation. Perhaps the rule derives in part from a naively literal application of the idea that a corporation is a legal person, to be treated as if it were a natural person: a natural person does not realize gain by giving away appreciated property to the objects of his affection, and so neither should a corporation realize gain by distributing appreciated property to its shareholders.

But whatever the reason for the General Utilities rule, it has proved in practice to be a great and continuing source of mischief and controversy. The basic trouble is that it permits (invites and induces) the arrangement of transactions, particularly acquisition transactions, to produce a step-up in the basis of corporate assets without any corresponding corporate tax. Since the result of stepping up basis is to produce exclusions or deductions from taxable income in the hands of the transferee, the net result is uncompensated erosion in the corporate income tax base, together with all the distortions of behavior any such erosion is apt to produce.

The Congress has already responded to exploitation of the General Utilities rule by repealing it piecemeal in many situations. As to depreciable property, we have depreciation recapture, which cuts across the General Utilities exclusion. Other special statutory rules apply to installment obligations and to LIFO inventory. Nonstatutory exceptions have been hammered out in litigation covering earned but uncollected income items and recovery of previously deducted items other than depreciation.

In addition to all these various direct exceptions, there has been a different kind of special response to some corporations formed or utilized with a view toward exploiting the General Utilities rule. Such corporations are labelled collapsible. Under some circumstances the consequence of collapsibility is imposition of corporate tax; under others it is recharacterization of shareholder gains as ordinary income. Presumably because of the potentially drastic harshness of this response, the collapsible corporation provision is fitted out with a series of exceptions and limitations, which often operate to give well-advised taxpayers effective ways to avoid its application altogether.

The Committee Staff and ALI proposals both would eliminate all these problems by repealing the General Utilities rule itself, substituting the simple, measured general rule that a corporation must recognize gain on any disposition of appreciated property except one in which basis carries over to a corporate transferee. This reformulation would produce enormous simplification, superseding the present piecemeal exceptions to the General Utilities rule and making it possible to repeal the collapsible corporation provision. Beyond simplification, this change would produce a much more even-handed application of the income tax and would ameliorate the unproductive bias of current law in favor of corporate acquisitions shaped to take advantage of the exclusion.

Both the Staff and ALI proposals would except goodwill from the repeal of General Utilities, since a step-up in basis of goodwill will not reduce subsequent taxable income. Moreover, the ALI proposals contain a special narrow credit for selling shareholders designed to provide relief from concurrent imposition of corporate and shareholder capital gain taxes. The Staff report indicates willingness to consider this and other possible sorts of specific relief. While provisions for relief might reintroduce some of the complication eliminated by repeal of General Utilities, there would still be an enormous net simplification. Moreover, relief can be shaped sensibly to what deserves relief, which is much better than letting it be defined as what is not caught up in the web of piecemeal repeal of General Utilities that characterizes present law.

3. Differences and Similarities between the Committee Staff and ALI Proposals. There are a number of differences

in detail between the Committee Staff and ALI proposals. I will mention a few. The ALI proposals make provision for limited use of a so-called purchase premium arising in certain acquisitions; the Committee Staff proposals would simply omit purchase premium in the case of all carryover-basis acquisitions. The ALI proposals prohibit simultaneous cost-basis and carryover-basis transfers between any particular corporate groups; the Committee Staff proposals, reflecting difficulties experienced with section 338, set forth a more specific but lenient rule requiring consistency only on an entity-by-entity basis. As mentioned before, the Staff proposals leave open the question whether any special relief from concurrent imposition of corporate and shareholder capital gain taxes should be provided; the ALI proposals contain a very specific relief provision in the form of a credit for corporate capital gain taxes against shareholder capital gain taxes.

I do not propose to dwell on these differences or to evaluate the relative merits of the Staff and ALI positions at this time. The important thing about the Committee Staff and ALI proposals is not their differences in emphasis or detail but their agreement on common themes. The differences tend to confirm, indeed, the fact that the common themes have survived the test of examination and elaboration by two quite independent working groups. From the Committee's standpoint, I should think the ALI proposals stand as independent confirmation that abandoning the reorganization definition and overruling General Utilities will indeed lead in the direction of simplification and clarification and will not prove in practice to have unanticipated complicating implications.

ALI consideration of its proposals is no substitute, of course, for consideration by other interested groups as well. But still, the ALI procedure is one of lengthy deliberation by distinguished expert panels. The Reporter in this project was closely guided from the beginning by about a dozen consultants who met typically two or three times a year for two or three days each time, to assist, advise, question and criticize in the early stages of formulation of the proposals. The consultants are listed in the front of the ALI Report; I cannot imagine that a more distinguished, diligent, or intelligent group of tax law practitioners (and teachers) could be assembled. Tentative drafts were subsequently distributed to and considered by the Tax Advisory Group, a larger panel of leading tax lawyers from around the country, also listed in the front of the report. This group met several times for several days each time. Drafts were then discussed and finally approved by the Council of the Institute and the membership in annual meeting assembled. Both the consultant and advisory group meetings were attended also by a liaison committee from the Tax Section of the American Bar Association and by personnel from the Treasury Department and Congressional Committee staffs.

The relation of the ALI work to the Staff proposals is twofold. It stands as a source of argumentation and elaboration - in some cases along alternative lines - of the main themes of the Staff proposals. But also it stands as affirmation from a significant quarter in the practicing bar of the practical workability of these main themes. I hope the Committee will find that the ALI work helps it to conclude that the Staff proposals are indeed sound and promising and deserving of prompt attention, support and enactment.

Special Limitations on Loss Carryovers

Special limitations on carryover of losses and other tax benefits have been subject to special attention in the formulation of both the Staff and ALI proposals. This is partly, in both cases, because of the special situation surrounding section 382, with amendments adopted in 1976 currently scheduled to go into effect next year.

Again the Staff and ALI proposals vary in detail but concur in purpose and general outline. Essentially the proposal in both cases is to eliminate the procedure of disallowing carryovers, in full or proportionately, and shift to a system of limitation. Carryovers would be allowed in full up to the amount of the limit, with the result that if tax benefits are small in relation to the limit they would survive unimpaired, while if they are the main thing, their deduction would be severely limited. The limit would be based on price paid in purchase acquisitions, and on an appropriate share of taxable income following merger acquisitions, and would be designed in both cases to provide a kind of rough approximation of the income the loss corporation might have earned itself through a successful reinvestment of its own assets. The controlling overall objective is to try to have a simple mechanical rule that will cause the value of tax carryovers to be preserved but not enhanced in acquisition transactions.

Earnings and Profits and Intercorporate Dividends

Taxable dividends have long been defined in our law as distributions out of earnings and profits accumulated since the effective date of the modern income tax, March 1, 1913, or, since 1936, out of earnings and profits of the current year. On its face this definition is totally plausible, appearing to exclude only distributions that do not represent income or profit and therefore ought not to be taxed as such. But that appearance is misleading; in practice, the earnings and profits requirement has led to a parade of unacceptable results. Some of these have been corrected, but only in ad hoc fashion and only after they have been enjoyed to some substantial extent by taxpayers astute or fortunate enough to stay ahead of statutory changes.

The original accumulated earnings and profits requirement, for example, was construed to have the effect that if a corporation suffered large losses, but then subsequently turned profitable and began to distribute those profits to shareholders (rather than accumulating them to restore the original losses), the distributions would not be taxed as dividends. This result was reversed, in general, by making current earnings an alternative source of taxable dividends, though schemes still exist for using old losses to alter the characterization of current distributions.

For a more recent example, upon the advent of accelerated depreciation in 1954, earnings and profits suddenly had the effect that many corporations paying out a high percent of their financial earnings would find their dividends to be nontaxable returns of capital, for tax purposes. This was precisely the situation for many utility companies, and so their dividends became largely nontaxable. The statute was ultimately amended to provide that earnings and profits should be computed on the basis of straight-line depreciation, but not until after substantial sums had been distributed without tax. Moreover, depreciation is not the only deduction the tax law permits on an accelerated basis, and some companies have succeeded in playing the same game with others accelerated deductions.

In addition, the corrective itself, computing earnings and profits to exceed taxable income by reason of smaller depreciation deductions, has disruptive effects on other applications of the earnings and profits concept where some degree of correspondence with taxable income is essential to its operation. Under the Consolidated Return Regulations, for example, basis of subsidiary shares is adjusted upwards for accumulated earnings and profits. The manifest purpose is to give basis credit for taxes paid on taxable income of the subsidiary. The effect of computing earnings and profits on the basis of straightline depreciation is to increase basis by more than taxable income, which makes no sense whatever. New unacceptable results seem likely to continue to emerge as long as the earnings and profits limitation itself is left in place. The Committee Staff proposes, at least as an alternative, that the problem be dealt with comprehensively by eliminating the earnings and profits requirement itself.

I need to emphasize that this topic is one on which the ALI work and proposals have nothing to say; the question of dividend definition simply was not taken up in the current ALI project. Earnings and profits is a topic, however, to which I have myself given a lot of thought, and I am thoroughly convinced that the Staff proposal to eliminate the requirement altogether is a sound one.

Earnings and profits serves other purposes under the tax law besides dividend definition, and would need to be preserved as a concept for these other purposes in any event. It has been argued that if the concept needs to be preserved for other purposes anyway it might as well be left in the dividend definition. But the fact is that acceptable computations of earnings and profits for purposes of dividend definition are often unacceptable for other purposes, and vice versa. It is an advantage of the Staff proposal, therefore not a drawback, that it would permit earnings and profits to be computed more sensibly for other purposes if the dividend definition aspect were eliminated.

Intercorporate Dividends

Dividends received by one corporation from another are 85 percent tax exempt to the recipient, or 100 percent in the case of a parent's dividends from a subsidiary. The rationale for the rule is apparently simple enough - to prevent a cascading of corporate income taxes on a single item of income as it flows from corporation to corporation. The rationale and the rule both work quite satisfactorily, too, in the case of parent-subsidiary relations and other substantial, permanent intercorporate investments.

But for mere portfolio holdings and transitory investments, the intercorporate dividend exemption makes little sense. Moreover, the result of the rule is to make the tax rules for corporate investors just opposite of what they are for individuals, dividends being the preferred form of return instead of the most heavily taxed. For traded shares, this incongruity generates opportunities for arbitrage that are now apparently the object of regular, active exploitation by sophisticated taxpayers.

I believe, personally, that it would be sound to repeal the dividend-received deduction entirely for mere portfolio and transitory holdings. This is again a matter on which there is no ALI proposal, although there is some discussion of the matter in an appendix to the ALI report.

The Committee Staff proposes two limitations on the dividend-received deduction. For one thing, the Staff would disallow interest on debt incurred or continued to purchase or carry dividend-paying shares, except stock of controlled subsidiaries. This would amount to a kind of indirect disallowance of the dividend-received deduction in some cases. It is not entirely clear to me why the dividend-received deduction should be indirectly disallowed for corporate borrowers but not for other corporations. The other Staff proposal would disallow the dividend-received deduction directly for dividends on shares held for less than a year. This suggestion seems to me to be entirely sound.

Conclusion

The Committee Staff's Preliminary Report contains valuable proposals to deal soundly and sensibly with a wide variety of problems. In closing, I should like to reiterate that some of its proposals also have the quality of being in substantial accord with proposals recently adopted and published by the American Law Institute, and as to these particularly I think the Committee Staff proposals offer very substantial immediate opportunities for simplification and improvement. I earnestly hope the Committee and the Congress will seize those opportunities.

Thank you.

STATEMENT OF EDWARD N. DELANEY, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, WASHINGTON, D.C., ACCOMPANIED BY JOHN B. JONES, JR., COVINGTON & BURLING, WASHINGTON, D.C.

Mr. **Delaney**. I am Edward Delaney, Mr. Chairman, and I am the chairman of the tax section of the American Bar Association; but I speak today only on behalf of the tax section.

The section believes that a more cohesive and rational set of rules in this important area of the tax law are needed. We very much appreciate the commitment and efforts made in attempting to achieve that objective, and are especially pleased that in the course of their study the staff and the joint committee staff consulted with members of the private tax bar. We hope that that collegial process will continue—it has been very successful in past legislative efforts.

The section is generally in agreement with the stated principal goals of the proposals: simplification, tax neutrality, the elimination of certain tax-motivated transactions, and strengthening of taxpayer compliance. To the extent that the proposals go that way, we are very much in support of them.

I am going to shorten our statement considerably to meet the time constraints you have imposed, but we will be prepared to answer questions.

We do have some problems with, for example, complete elimination of the earnings and profits test. We think that is premature.

We would have some problems with the disallowance of the interest deduction as it is set up for the curing of abuses through holding common and preferred stocks.

We do agree that in the dividend area there are some problems and they should be looked at, but the solution should be directed to the specific problems.

As to the limited partnerships, we have taken a position that they should not be treated as corporations; but we are prepared to restudy that, since our recommendation was really engendered out of a different perspective. So we would be prepared to restudy that particular issue.

The section views the staff's preliminary report as a major contribution to the process of reforming and simplifying these rules. We stand ready to assist the staff in any further work in this area.

The **Chairman**. Thank you very much.

Mr. Taylor.

[Mr. Delaney's prepared statement follows:]

STATEMENT OF

EDWARD N. DELANEY, CHAIRMAN

SECTION OF TAXATION

of the

AMERICAN BAR ASSOCIATION

before the

COMMITTEE ON FINANCE
UNITED STATES SENATE

with respect to

the Reform and Simplification
of the Income Taxation of Corporations

October 24, 1983

I am Edward N. Delaney, Chairman of the Section of Taxation of the American Bar Association. I appear today to express the views of the Section regarding the proposals on the income taxation of corporations contained in the recently issued preliminary report of the Finance Committee Staff.[1/] The views I express represent only those of the Section, and should not be construed as representing those of the American Bar Association as a whole.

The Staff proposals recommend fundamental and far-reaching changes in the rules governing the taxation of corporate transactions. Obviously, these proposals are the result of thoughtful consideration by the Staff and other knowledgeable people, and we commend them and you for this effort. The present rules have evolved piecemeal over several decades. Consequently, they have become quite technical and complex; and their application can sometimes lead to arbitrary and irrational results.

The Tax Section believes that a more cohesive and rational set of rules in this important area of the tax law are needed. We very much appreciate the commitment and efforts made in attempting to achieve that objective, and are especially pleased that, in the course of their study, the Staff consulted with members of the private tax bar. We sincerely hope that this collegial process will continue.

[1/] Preliminary Report Prepared by the Staff of the Senate Committee on Finance, entitled "The Reform and Simplification of the Income Taxation of Corporations," September 22, 1983 (hereinafter referred to as the "Staff proposals").

The Section is generally in agreement with the stated principal goals of the proposals: simplification; tax neutrality; the elimination of certain tax-motivated transactions; and strengthening taxpayer compliance. Since the proposals are not accompanied by suggested statutory language, we cannot now say with assurance that the numerous specific amendments to the Internal Revenue Code which would be necessary to implement the proposals would indeed accomplish these goals without introducing substantial new problems.

As you can appreciate, there is a diversity of views within the Section as to whether some or all of the proposals can be reduced to legislative language which would simplify and improve upon present law, and whether the proposals can serve as a basis for meaningful legislative change. Given the controversial subject matter involved, this diversity of early reactions to the proposals is not at all surprising. Let me assure you that the Section fully intends to proceed with a detailed review and evaluation of the proposals and any bills which may emanate from them.

Before addressing the five areas on which specific comments were requested in the Committee press release announcing this hearing, I would like to begin with some general observations regarding the proposed changes in the taxation of corporate acquisitions.

Taxation of Corporate Acquisitions

The Section has long been concerned that the rules governing whether a corporate acquisition qualifies for tax-free treatment are unnecessarily complex and often distinguish between essentially similar transactions based on technicalities of form. In 1981, after an extended study by its Committee on Corporate Stockholder Relationships, the Section adopted a legislative recommendation which would substantially streamline and make more uniform the definitional provisions of the Code relating to corporate reorganizations.[2/] Under this recommendation, the fundamental present law distinction between taxable and tax-free acquisitions would be retained -- namely, that at least some minimum portion of the consideration paid for the stock or assets of the acquired corporation must consist of stock of the acquiring corporation or its parent.

The Staff proposals would eliminate the requirement of stock consideration as well as other traditional distinctions between taxable and nontaxable corporate acquisitions. Their central concept is that in acquisitions of either a controlling stock interest in, or substantially all the assets of, a corporation, the parties will be permitted to elect taxable or tax-free treatment of the transaction at the corporate level. The necessary corollary of taxable

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2/ Recommendation No. 1981-5, reported at 34 Tax Lawyer 1386 (1981).

treatment is that the tax basis of the assets of the acquired company would be stepped up to reflect the fair marekt value of the assets, whereas in a tax-free transaction the asset basis would continue unchanged.

Shareholders of the acquired corporation receiving stock in connection with a qualified corporate acquisition would be entitled to tax-free treatment irrespective of whether the transaction is taxable or nontaxable at the corporate level, and irrespective also of whether, or how much, stock is received by other shareholders. Thus, the "continuity of interest" requirement under present law would be abolished; and the tax treatment of the transaction would not be subject to challenge by reason of pre-acquisition changes in ownership of the acquired corporation's stock, or post-acquisition dispositions of stock received in the transaction.

We are generally sympathetic with a tax regime under which the form of a particular acquisitive transaction takes does not determine its tax consequences. While it is true that present law effectively provides taxpayers with the flexibility to structure most acquisitons of corporate stock or assets as taxable or nontaxable, it does so in a complicated manner and often places a premium on the ability of the parties to avail themselves of sophisticated tax advice. The Section's 1981 recommendation was formulated on the assumption that the law would continue to require at least some minimum stock consideration as a pre-condition to tax-free treatment. As expressly noted in the report accompanying the recommendation, we remain open to the possibility of endorsing broader proposals, such as those of the American Law Institute and the Committee Staff, which would eliminate the stock consideration and related continuity of interest requirements.

Because consideration of the Staff proposals is still in its early stages, we are not yet in a position to offer detailed comments as to the operation and implications of the proposed revamping of the corporate acquisition rules. Based on our preliminary review, however, one area which troubles us is the inclusion of an entity-by-entity "consistency rule" with respect to the election as to whether a transaction would be taxable or tax-free. Such a rule would no doubt foster in many instances the otherwise unnecessary formation of multiple corporations. We question whether any consistency rule is really needed.

I will now turn to the specific questions that the notice of this hearing requested witnesses to comment on.

1. Distributions of Appreciated Property

Comments were specifically invited on whether, if gain is taxed to the corporation on a distribution of appreciated property, it would be appropriate to provide some relief either on a temporary or permanent basis. Since the Staff proposals would also require gain recognition to a corporation where there is an acquisition giving rise to a cost basis election, there is a further question whether possible relief proposals would also extend to cases where there is gain to an acquired corporation in connection with a corporate acquisition, whether or not accompanied by a liquidation.

The Staff proposals embody important changes in present law which could have a materially adverse impact on longstanding taxpayer expectations associated with the conduct of business activity in corporate form. We therefore believe that transitional relief is appropriate with respect to situations where there would not be tax at both the corporate and shareholder levels under present law.

The Staff proposals suggest the possibility of phasing in capital gains tax resulting from application of the new rule. This would appear to be a reasonable approach. Another transitional alternative which warrants consideration would be to grant special tax relief in connection with liquidations of existing corporations during the first 2 or 3 years following enactment of the new rules.[3/]

We also believe that some form of permanent relief is appropriate. The Staff proposals mention five possible options. Of these options, we have some concern that the shareholder credit, although theoretically appealing, might be too difficult to administer. We would be more favorably inclined towards either exempting certain corporate assets held for some specified minimum time period, or permitting deferral of the corporate and/or shareholder level tax where corporate assets are distributed in kind to the shareholders in a complete or partial liquidation. The former approach would probably be easier to administer.

We further believe that apart from any of the options suggested by the Staff proposals, a special exemption from the corporate level tax should apply with respect to certain closely-held corporations -- defined, for example, with reference to the personal holding company shareholder test and with a relatively low maximum asset level and a maximum number of shareholders requirement as well.[4/]

[3/] There is recent precedent for such an approach in the provisions which permit transitional liquidations of personal service corporations. *See* P.L. 97-428, § 247.

[4/] If this approach were adopted, it probably would be necessary to fashion an appropriate anti-avoidance rule to deal with the fragmentation of assets in multiple commonly controlled corporations.

Such corporations are essentially similar to partnerships and proprietorships, and it would be desirable from a tax policy standpoint to prevent the double tax impact which would be avoided if the business were conducted in one of these other forms.

2. Intercorporate Dividends Received Deduction

The second point on which comments were particularly requested was whether allowance of the 85% dividends received deduction, when coupled with full deductibility of a short-term capital loss on a sale of the underlying stock, constitutes a loophole or unintended benefit.

We agree that allowance of both the dividends received deduction and the loss on a sale of the stock resulting from a drop in price after the ex-dividend date provides an unintended tax benefit.

The Staff proposals include a two-pronged limitation on the 85% dividends received deduction. The proposals would require a minimum one year holding period for eligibility for the dividends received deduction, and also would disallow a deduction for 85% of the interest on debt incurred to purchase or carry stock (both common and preferred) the dividends on which would be eligible for the dividends received deduction. While we are not yet in a position to suggest a suitable alternative, we believe that these proposals go far beyond what is necessary to cure the stated evil.

To the extent that the principal abuse motivating the dividends received deduction proposals involves the issuance of preferred stock with mandatory dividend features, the solution embodied in the proposals is not responsive to the real tax issue -- namely, whether the preferred stock is in fact debt, and if so, whether there should be a deduction at the corporate level for the payment.

We understand that the proposed interest disallowance would not involve a tracing concept and, therefore, could result in the arbitrary disallowance of interest where a corporation having normal business borrowings holds stock qualifying for the dividends received deduction. If further consideration is to be given to this proposal, the reasoning behind it is such that it would be preferable to cast any limitation as an explicit limitation on the availability of the dividends received deduction in specific cases.

3. Earnings and Profits Limitations

Comments were requested on whether (a) the earnings and profits limitation on dividend treatment of distributions by corporations provides opportunities for abuse; (b) the earnings and profits limitation on dividends should be repealed; and (c) a narrow set of revisions to the earnings and profits rules should be attempted in lieu of repeal.

We agree that the current earnings and profits rules do permit certain abuses (for example, the distribution of appreciated property in certain circumstances) and that considerable uncertainty exists concerning the manner in which earnings and profits are to be computed. We submit, however, that the wholesale elimination of the earnings and profits limitation for purposes of determining the amount taxable as a dividend is not the appropriate response to such problems.

While problems and uncertainties exist in the present earnings and profits rules, the concept is intended to limit the taxation of distributions as dividends to cases where the corporation has realized corresponding profits. We believe that such a limitation is generally desirable, although some carefully defined exceptions may be needed.

Apart from its dividend measurement function, the concept of earnings and profits is key to the application of a number of other provisions of the Internal Revenue Code. That would continue to be so under the Staff proposals, with the result that many of the complexities inherent in the computation of earnings and profits would remain. Both large and small corporations would continue to be required to maintain earnings and profits accounts for these other purposes.

Moreover, it would seem that the problems and complexities in this area could be better dealt with by making narrower changes in the existing earnings and profits rules. For example, one clear change which we would favor would be to require that earnings and profits be reduced by the fair market value of any debt obligation distributed to shareholders (rather than by the principal amount of such obligation). Other rules may warrant change as well. We will continue to study this subject.

Finally, it should be noted that the Staff proposals implicitly recognize the inequity of blanket dividend treatment for all corporate distributions by suggesting a limited "return of capital" exception for certain distributions to shareholders who made capital contributions to the corporation. While this exception would probably be workable in straightforward situations (e.g., sole shareholder contributions), it could prove very difficult to administer in a variety of other situations (e.g. where contributions are made over a period of time, or where multiple contributors are involved).

4. Limitation on Net Operating Losses and Other Tax Attributes

As indicated in my testimony last month before the House Ways and Means Subcommittee on Select Revenue Measures, the Section believes that the guiding principle in limiting the carryover of tax attributes should be neutrality. Limitations should be applicable when the economic value of tax attributes may be abnormally inflated. As we understand them, the Staff proposals are intended to limit post-acquisition utilization of attributes by reference to what the loss company's utilization would have been had no acquisition occurred. We generally support this approach.

In order to permit further study and refinement of both the House and Senate proposals, we urge a further extension of the presently scheduled January 1, 1984 effective date for the 1976 amendments to section 382. The Section believes that the 1976 amendments are too complex and in many respects arbitrary and irrational, and that it would be a serious mistake to allow them to go into effect.

We believe it very important that the effect of the attribute limitations should be clear and readily calculable. In that regard, because of the generality of the Staff proposals and certain questions which they raise, there are a number of areas where we feel that further review and study are required.

The Staff proposals would replace the existing rules with a system based on the principle that when a change in the ownership of a corporation has occurred, loss carryovers will be allowed only to the extent that the income of the acquiring corporation or group of corporations is attributable to the same pool of capital that generated the loss. The proposals employ two distinct rules in limiting loss utilization -- the "merger rule" and the "purchase rule."

The existence of separate rules for cash and non-cash transactions (and the use of both rules in a transaction involving mixed consideration) introduces complexities that would be avoided if one rule governed all types of transactions. Furthermore, the use of two rules may influence to an undesirable degree the form of consideration used in acquiring a loss corporation. For example, a non-cash acquisition might be chosen to avoid the fixed upper limit on annual loss utilization that would be imposed by the purchase rule. Thus, we suggest that further consideration be given to the possibility of utilizing a single rule for limiting loss utilization.

The Staff proposals raise a number of other operational issues. For example, both the merger rule and the purchase rule implicitly assume that the loss corporation has loss carryovers in an amount sufficient to completely and permanently shelter its income. In the case of a loss corporation that has only modest loss carryovers in comparison with the income that its assets are expected to generate. each of these rules would result in an unduly severe limitation on loss utilization, thus creating an economic bias against acquisition of the loss corporation. As another example, if a loss corporation acquires a profitable corporation (or its assets) in exchange for stock, and the shareholders retain at least 80% of its stock, there is no limitation on loss utilization. If, on the other hand, the profitable corporation acquires the loss corporation (or its assets) in exchange for 80% or more of the profitable corporation's stock, there will be a limitation on loss utilization. This lack of symmetry would create an undesirable bias in favor of placing the loss corporation in the role of the acquiring corporation in this case.

The treatment of built-in losses is another area which warrants more careful attention. Heretofore, the utilization of built-in losses has been governed by the consolidated return regulations and case law under the corporate acquisition tax avoidance rules of section 269 of the Code. The Staff proposals indicate that built-in losses will be determined under regulations to be promulgated by the Treasury. Because the Staff proposals also contemplate the repeal of section 269, we urge that consideration be given to confronting the matter of built-in losses through express statutory provisions.

5. Publicly-traded Partnership Interests

As part of its corporate tax proposals, the Staff has suggested that consideration be given to treating limited partnerships with interests trading on an established securities market as associations taxable as corporations for tax purposes, rather than as partnerships. Recently, the Section of Taxation, working from a different perspective, made a legislative recommendation to the American Bar Association that such limited partnerships should not be taxed as corporations.

We recognize the concern that implementation of the Staff proposals with regard to the taxation of corporations would likely place a further and unforeseen strain on the entity classification issue. Therefore, we will be reexamining the issue to determine whether a change in our position should be considered.

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In conclusion, let me reiterate that the Staff proposals go to the very fabric of the rules governing the taxation of corporations and their shareholders. The Section views the Staff's preliminary report as a major contribution to the process of reforming and simplifying these rules, and we stand ready to assist in that process in any way we can.

STATEMENT OF WILLARD B. TAYLOR, ESQ., SULLIVAN & CROMWELL, NEW YORK, N.Y.; AND HERBERT L. CAMP, DONOVAN LEISURE NEWTON & IRVINE, NEW YORK, N.Y., ON BEHALF OF THE NEW YORK STATE BAR ASSOCIATION, NEW YORK, N.Y.

Mr. TAYLOR. My name is Willard Taylor. I am the chairman of the tax section of the New York State Bar Association and here on its behalf. With me is Herbert Camp, cochairman of the section's committee on corporations.

We support the proposals with respect to corporate acquisitions and liquidations, but believe that there should be some form of permanent relief, either by shareholder credit for the corporate capital gains tax or reduction in the corporate capital gains tax.

With respect to the 85 percent dividends-received deduction, we believe that the specific abuse cited in the press release could be fixed by fairly minor surgery to present law. It does not justify, in our view, the broad 1-year holding period proposed by the staff or the interest deductibility proposal.

We acknowledge there are real problems with respect to the earnings and profits limitation on the dividend treatment of corporate distributions. We believe they should be dealt with but do not believe they justify the elimination of the limitation.

With respect to the net operating loss provisions, we support them, particularly insofar as they propose a merger rule. If, however, you conclude that a purchase rule is desirable because it would permit a single rule, we think that the purchase rule is preferable to what we now have or will have at year end if the scheduled law change goes forward.

With respect to publicly traded limited partnerships, we believe that they should be treated as corporations, but we believe that this would be a change that ought to be made only in connection with a broader consideration of the entity classification.

That's the end of my summary. We have filed a full statement.

The CHAIRMAN. Mr. Battle.

[Mr. Taylor's prepared statement follows:]

STATEMENT OF THE NEW YORK STATE BAR ASSOCIATION TAX SECTION

The Reform and Simplification of the Income Taxation of Corporations

My name is Willard B. Taylor. I am the Chairman of the Tax Section of the New York State Bar Association and appear here on its behalf. With me is Herbert L. Camp, Co-chairman of the Tax Section's Committee on Corporations.

The Tax Section has over 2,800 members, all of whom are lawyers with a professional interest in taxation. They include practicing lawyers, judges, professors of law, corporate counsel, and officials and employees of the Treasury Department and the Internal Revenue Service.

Members of the Tax Section have given advice to the Senate Finance Committee Staff over the past few months in its preparation of its preliminary proposals,* and we appreciate this opportunity to comment on those proposals.

Our comments here are only general since the proposals, not being in legislative form, are themselves also general. If legislation is proposed, we hope to have the opportunity to submit detailed comments. We also urge that in its consideration of the proposals Congress move deliberately and without haste.

Our comments are organized around the specific questions on which comments were requested by the press release that announced this hearing*. As set forth in more detail below, we support the merger and acquisition and net operating loss carryover proposals of the Staff but have serious reservations on some of the other proposals.

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* The Reform and Simplification of the Income Taxation of Corporations, a Preliminary Report prepared by the Staff of the Senate Committee on Finance (September 22, 1983).

1. The 85% dividends received deduction. The press release asks whether the allowance of an 85% dividends received deduction coupled with the full deduction of a short-term loss on a later sale of the stock is a loophole or unintended benefit.

It seems to us that no loss has been sustained by a corporation to the extent that the price which it pays for stock anticipates the payment of a dividend that is eligible for the 85% dividends received deduction and the loss results from a corresponding drop in price after the stock goes ex-dividend. To allow both the dividends received deduction and a deduction for the loss on a sale of the stock in such a case is a doubling up that could appropriately be corrected by legislation.

The Staff's dividends received deduction proposal, however, is far broader. It goes beyond the situation described in the press release or any other specific situation cited in the Staff's report. By extending to more than one year the holding period required for eligibility for the dividends received deduction and disallowing 85% of any interest expense incurred to purchase or carry stock on which the dividends are eligible for the dividends received deduction (determined by an "objective" rule), the Staff's proposal would go a long way towards repealing the 85% dividends received deduction for many corporate shareholders.*

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* Press Release No. 83-186, October 4, 1983.

The Federal income tax system has from its inception provided for a dividends received deduction, and repeal in whole or in part of the current 85% deduction would be a profound change. The theory of a dividends received deduction is that corporate income should be taxed only once until distributed to individual or other non-corporate shareholders, and it is in no sense inconsistent with this theory to allow a corporate shareholder an unlimited deduction for interest incurred to purchase or carry stock that pays dividends which are eligible for the deduction. Although we recognize that allowing a dividends received deduction is not consistent with this theory if the corporation paying the dividend pays no taxes, we are not sure there is any better way to make sure that there is only one tax at thecorporate level.* Certainly the Staff's proposal would not do this, since it could in effect tax the same corporate income to both the paying and receiving corporation.

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* In this regard, we did not, as stated in the Staff's preliminary proposals, identify the general issue of the deductibility of interest incurred to purchase or carry stock as a "significant corporate tax shelter problem." Our January 1983 submission to the Staff, suggesting a "limited project" in this area, was directed at transactions in which nonrecourse debt was incurred to purchase an issue of preferred stock structured to service the interest and principal on the debt, not to the broader question of whether there should be a disallowance of any interest incurred to purchase or carry stock.

If the Staff's proposal is nonetheless to be adopted, we urge that it not be done until representatives of affected industries have been consulted. Repeal or curtailment of the dividends received deduction will have a major impact on corporations that raise capital by issuing stock. This aspect of the Staff's proposals has received less publicity than others and has not been brought to the attention of many businesses that would be affected by it.

We also question whether the Staff's interest deductibility proposal, if adopted, should apply to interest incurred after the end of 1983, or any other fixed date, to purchase or carry stock issued prior to that date. In our experience, a great deal of stock has been issued or now trades on the assumption that the 85% dividends received deduction will be allowable, and in some cases issuers have indemnified corporate holders against the risk that the deduction would be lost. An interest deductibility rule that does not at least defer its application to outstanding stock will penalize either the issuer or the holders.

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* Allowing a deduction for dividends paid to corporations or limiting the dividends received deduction to dividends paid by tax paying corporations would present serious problems of administrability.

If the Committee chooses only to deal with the specific situation described in the press release, we believe that requiring a more than one-year holding period for eligibility for the 85% dividends received deduction, as proposed by the Staff, is much more than is needed. The perceived abuse exists only where there are mandatory dividends (such as dividends that have been declared but not yet paid or those commonly required by preferred stocks), since otherwise the price will not anticipate the dividend; and only where there is a ready market for the purchase and sale of the stock. To deny the 85% dividends received deduction for dividends paid on any stock held for one year or less will deny the deduction in many cases in which this is not the case.

To fix the case described in the press release, it should be enough to provide that a corporate purchaser of stock that is traded on an established securities market and requires the payment of a dividend must reduce its basis by the part of the purchase price attributable to the accrued dividend -- the same rule that now applies to debt obligations purchased between interest payment dates. In the alternative, it could be provided in such a case that the dividend is not eligible for the 85% dividends received deduction unless the stock has been held for all or a specified substantial portion of the period in respect of which the dividend is paid -- the quarter, for example, in the case of a stock providing for a quarterly dividend.* The rules relating to the calculation of any required holding period should be, as the Staff suggests, tighter than under present law.

2. The earnings and profits limitation. The press release asks whether the earnings and profits limitation on dividend treatment of corporate distributions should be repealed or whether there should be a narrower set of revisions to that limitation.

While there are many problems with the present earnings and profits limitation, some form of limitation is consistent with the basic notion that a corporate distribution is not income if it is not paid out of earnings realized by the corporation. Earnings and profits is relevant throughout the Internal Revenue Code, moreover, and its repeal only as a limitation on the dividend treatment of corporate distributions will not be an important simplification.* Earnings and profits will continue to be central to the calculation of the indirect foreign tax credit, to the treatment of controlled foreign corporations and to many other situations. Nor does the Staff's preliminary proposal explain the relationship between repeal and the provisions of sections of the Code such as 306 or address the problems that may be created by repeal. Thus, while enlarging dividend treatment will increase tax liabilities if distributions are made to non-corporate shareholders, the situation is reversed if the distribution is eligible for the 85% dividends received deduction. Are we to believe that there will be no reduction in a corporate shareholder's basis for its stock on account of dividends that are not paid out of corporate earnings?**

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* A different rule would be needed for arrearages and other extraordinary dividends, such as, for example, one that ties the required holding period to the date on which payment of the arrearage is announced.

Without a full exploration of these and other problems, we would not support elimination of the earnings and profits limitation on the dividend treatment of corporate distributions. None of the supposed abuses cited in the Staff's preliminary report requires repeal of the earnings and profits limitation and some can be cured by changes in the regulations.* If the Committee concludes that there are specific problems, we recommend that they be dealt with by defining earnings and profits or by other specific revisions to the Internal Revenue Code or regulations. Defining earnings and profits, moreover, may permit the development of definitions that could be used elsewhere in the Internal Revenue Code and that would lead to an improvement in present law.

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* Indeed, the Staff's proposal to provide that a parent corporation's basis in a controlled subsidiary's stock is equal to the net tax basis of the controlled subsidiary in its assets, regardless of whether consolidated returns are filed, will in effect expand the need for corporations to make a calculation that in many respects is an earnings and profits calculation since net tax basis changes from year to year by an amount that may (apart from depreciation) approximate current earnings and profits or the current deficit in earnings and profits.

** This could permit corporate taxpayers to create capital losses at the price of income taxable at a 6.9% rate.

Among the narrow revisions that would make sense would be the elimination of the "current" or "accumulated" rule -- that is, distributions should be treated as dividends only if out of earnings and profits accumulated through year end. Enacted to serve a purpose that is no longer valid,** the rule that treats a distribution as a dividend if out of "current" but not accumulated earnings and profits does not seem not consistent with the purpose of the earnings and profits limitation.

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* For example, the rule in Regs. § 1.312-1(a) that earnings and profits are reduced by the principal amount (not value) of a distributed debt obligation could be changed by amendment to the regulations.

** It was enacted in 1936 as a relief measure in connection with a now-repealed tax on undistributed profits. See ¶7.02 Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders (4th ed. 1979).

3. Publicly traded limited partnerships. The press release asks whether limited partnerships with publicly traded limited partnership interests should be taxed as corporations.

A change in the classification of publicly-traded partnerships for tax purposes ought to be accompanied by a broader consideration of the partnership classification rules, and we also urge that such a study consider the possible integration of corporate and shareholder taxes.

With respect to specific question asked in the press release, we think that a limited partnership with publicly-traded limited partnership interests, if it carries on an active business, has enough corporate resemblance to justify taxing it as a corporation. A further reason for classifying such partnerships as corporations for Federal income tax purposes is the difficulty of collecting taxes from partners of publicly-traded partnerships, particularly taxes resulting from partnership audits.

Taxing existing limited with publicly-traded interests as corporations, however, would have a severe effect on their limited partners, and there is a compelling case for deferring for some period the application of such a rule to a partnership with limited partnership interests that were traded at the time of enactment and also for giving relief for any adverse tax consequences resulting from the deemed incorporation of the partnership.*

4. Limitations on net operating losses and other attribute carryovers. The press release asks what special limitations there should be on net operating loss and other carryovers in corporate acquisitions.**

The Staff's proposal essentially follows the proposals developed by the American Law Institute and is similar to the proposal on which hearings were held at the end of last month by the Subcommittee on Select Revenue Measures of the House Ways and Means Committee.*** These proposals apply two rules to the carryover of net operating losses and other attributes after an acquisition: a "merger" rule, which generally applies where the consideration consists in whole or in part of common or preferred stock and which limits the carryover to the post-acquisition earnings of the combined enterprise that are attributable to the stock that is issued; and a "purchase" rule, which applies to cash acquisitions and other cases where the merger rule does not apply and which limits the carryover to an interest-like return on the cash or other consideration.

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* For example, for any gain or recapture resulting from the incorporation.

** We have previously urged that consideration be given to making carryovers freely transferable. See New York State Bar Association Tax Section, Report on Section 382 of the Internal Revenue Code as amended by the Tax Reform Act of 1976, 31 Tax Law. 283 (1978). The press release implies that there must be limitations on carryovers, however, and we therefore assume that free transferability is not now under consideration by this Committee.

*** Hearings held on September 22, 1983 before the Subcommittee on Select Revenue Measures, Committee on Ways and Means.

We testified in support of such a proposal before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, taking that the view to it was sound, particularly to the extent it applied the merger rule to the fullest extent possible. We reiterate that support here. We also said, and repeat here, that Congress should allow itself time to deal comprehensively with tax attribute carryovers and that such legislation cannot be put in place by January 1, 1984, when Section 382 of the Internal Revenue Code, as amended in 1976, is scheduled to come into effect. We, therefore, suggest that the January 1 effective date be further extended for up to one year.

Since the merger rule cannot be applied in all cases (for example, a cash acquisition by a corporation that does not have traded stock), adoption of the merger rule inevitably means that there must also be a purchase rule. Contrary to some of the views expressed before the Subcommittee on Select Revenue Measures, we do not think that the existence of two rules is by itself a persuasive objection to the merger rule. If it should be concluded that there should be only one rule, however, we prefer a single purchase rule to present law or to the 1976 Act changes that are scheduled to come into effect at the end of this year. The differences between the merger and the purchase rule are quite small when compared to what we now have or will have at year end. A single purchase rule could either limit carryovers to an interest-like return on the purchase price or to a lump sum amount.

5. Relief from gain recognized on distributions of property and in cost basis acquisitions. The Staff's preliminary proposals with respect to corporate acquisitions and liquidations provide for the recognition of gain on a distribution of appreciated property by a corporation to its shareholders, whether in liquidation or otherwise, and by an acquired corporation in any acquisition in which there is a cost basis election, *i.e.*, an election to revalue the assets of the acquired corporation to cost.

The press release asks whether temporary or permanent relief is appropriate for gain taxed to a corporation on the distribution of appreciated property and, if relief is appropriate, how it should be structured. We assume that relief, if given, would also extend to the gain recognized by an acquired corporation in an acquisition for which a cost basis has been elected.

We have previously expressed our general support for the reform of Subchapter C and the decision to base the reform on the American Law Institute Federal income tax project.* Thus, we generally agree that the treatment of shareholders should be divorced from the treatment of the corporations that are parties to the acquisition, that whether there is a carryover or a cost basis for the assets of the acquired corporation should be determined by a simple election and should not depend on the form of acquisition or the consideration, and that shareholders should be given non-recognition treatment when they receive stock from a corporation that is a party to the acquisition, regardless of the form of the acquisition or of the consideration received by other shareholders. These proposals, based on extensive study over a period of years, are sensible. We have also expressed support for the Staff's proposals with respect to treatment of "boot" received by shareholders in a corporate acquisition.

Most of us, however, believe that permanent relief is appropriate if gain is to be recognized by a corporation on any distribution of appreciated property to its shareholders and in any acquisition in which the assets of the acquired corporation are revalued to cost. As to the form of relief, we would favor either a shareholder credit for the capital gains tax paid by the corporation or a reduction in the capital gains tax paid by the corporation. In either case, relief would be limited to the gain on long-held capital assets. The shareholder credit is more complex and would benefit only taxable shareholders. A reduction in the corporate tax would benefit all shareholders but, to be revenue neutral with a shareholder credit, would of necessity be less beneficial for taxable shareholders.

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* By letter of August 2, 1983 to Roderick DeArment, Chief Counsel to the Committee on Finance.

6. Other proposals. Of the Staff's other preliminary proposals, we would generally support the proposals with respect to the determination of the basis of the stock of a controlled subsidiary, the treatment of "boot" in non-acquisitive reorganizations and the definition of "control". On the other hand, the proposal to expand Section 1248 to provide for additional ordinary income treatment of gain realized on a disposition of stock in a controlled foreign corporation seems to us to bear no legitimate connection to any of the other preliminary proposals or, insofar as it relates to assets of the foreign corporation that would not generate Subpart F income, to any U.S. tax policy. We have no comment at this time on the Staff proposals relating to Section 367, the decontrol of controlled foreign corporations, liquidating distributions of installment obligations or the S corporation election.

STATEMENT OF FRANK V. BATTLE, JR., CHAIRMAN, FEDERAL TAXATION COMMITTEE, SUBCHAPTER C PROJECT, CHICAGO BAR ASSOCIATION, CHICAGO, ILL.

Mr. BATTLE. My name is Frank Battle. I am appearing today on behalf of the executive committee of the Federal taxation committee of the Chicago Bar Association.

I would like to begin by saying that in view of the scope of the proposals and the number of taxpayers who would be affected, it is our hope that the unhurried consideration of these proposals by Congress would allow them to be better understood by, and refined and honed by comments from the general public.

The CHAIRMAN. Right. We propose to do that.

Mr. BATTLE. I will limit my comments to the portion of the report dealing with the acquisition and disposition rules.

The committee strongly supports the election by corporate parties to such a transaction, to treat them as either as carryover-basis or cost-basis transactions, and also strongly supports the separation of the tax consequences applicable to the corporations from those applicable to their shareholders.

There is, however, no consensus among the members of the executive committee as to the appropriate treatment of the General Utilities principle. We do believe that the impact of the tax resulting from the repeal of General Utilities should be mitigated in a manner more permanent than the transition rules set out in the report; but, beyond that there is no clear consensus. Many of us believe that there should be some form of shareholder credit allowed, as has been stated, or an exemption for tax for historically held capital assets if the credit is viewed as too complex. Other members, and a significant number of the members of the committee, however, favor retaining current law.

I think it will be on this topic that it would be helpful to gather a consensus from the public.

The CHAIRMAN. Thank you very much.

[The prepared statement of Frank V. Battle follows:]

STATEMENT OF

FRANK V. BATTLE, JR., CHAIRMAN

of the

SPECIAL COMMITTEE ON
SUBCHAPTER C LEGISLATION

of the

FEDERAL TAXATION COMMITTEE

of the

CHICAGO BAR ASSOCIATION

before the

COMMITTEE ON FINANCE
UNITED STATES SENATE

with respect to
the report entitled

"The Reform and Simplification
of the Income Taxation of Corporations"

October 24, 1983

I am Frank V. Battle, Jr., Chairman of the Special Committee on Subchapter C Legislation of the Federal Taxation Committee of the Chicago Bar Association. I am pleased to appear today on behalf of the Executive Committee of the Committee on Taxation to present our preliminary views on the report, entitled "The Reform and Simplification of the Income Taxation of Corporations" (the Report). Because of the breadth of the proposals made in the Report and the shortness of time between publication of the Report and these hearings, we have not had the opportunity to solicit the comments of the full Committee on Taxation or the approval of the Board of the Chicago Bar Association of the statements made here today. We intend to continue carefully to examine the proposals made in the Report and to solicit the views of our membership.

We applaud the approach taken by the Staff in reaching the preliminary decisions set forth in the Report. In formulating its own proposals the Staff considered proposals made by the American Law Institute, the Section of Taxation of the American Bar Association, the American Institute of Certified Public Accountants and others. The Staff's examination of these proposals was undertaken in connection with the staff of the Joint Committee on Taxation, representatives of the Treasury Department and members of the bar. We believe that the Report considers a number of areas which deserve the attention of Congress. We believe that unhurried consideration of these far reaching proposals is essential to ensure that they will lead to legislation that will substantially improve the law. During that process the proposals will become better understood by the general public and will be refined and improved by comments from the public.

Turning to the proposals themselves, our comments are with respect to certain aspects of the proposals for corporate acquisitions and dispositions, for limitations on operating losses, for distributions and for entity classification. These comments are necessarily general in nature, but we will endeavor to comment more specifically as we continue our review of the proposals.

Proposals for Corporate Acquisitions

In general we support the proposals (1) to permit corporate parties to an acquisition simply to elect to treat the acquisition as either a cost basis acquisition or a carryover basis acquisition regardless of the nature of the consideration used to effect the acquisition and (2) to separate the tax consequences of an acquisition applicable to the shareholders of the corporate parties from those applicable to the corporations themselves. However, our views concerning the specifics of these proposals are influenced substantially by our attitudes on the proposal to repeal the General Utilities principle. It seems appropriate, therefore, to preface our statement on the acquisition proposals with a discussion of that proposal.

The Executive Committee does not support repeal of the General Utilities principle in the manner proposed in the Report. Beyond that statement, however, the views of the members of the Executive Committee are varied. Some believe that the impact of the tax arising from the repeal of General Utilities should, in the case of a complete liquidation, be mitigated by allowing the shareholders of the liquidating corporation a credit against the tax on the gain realized as a result of the liquidation for the tax paid by the liquidating corporation. This accords with the conclusions of the American Law Institute's Subchapter C proposals. Others believe that the implementation of such a credit, particularly in the case of persons who sell shares around the time of liquidation, would be very complicated. Accordingly, they would prefer an exemption from the corporate level tax in the case of a transfer of capital assets which have been held by the corporation for some minimum period of time. Still others believe that the impact of the tax resulting from the repeal of General Utilities will be substantial and will be borne primarily by closely held corporations. Such persons would prefer retaining the provisions of current law (Sections 336 and 337) which generally exempt corporate transferors from tax in transactions in which the corporation is completely liquidated.

As stated above our views on numerous aspects of the proposals for corporate acquisitions are influenced by the outcome of the General Utilities issue. If the General Utilities principle is repealed as proposed in the Report, we believe that certain of the limitations contained in the proposals are unnecessary. The repeal of the General Utilities principle would mean that a transfer of a corporate asset to a transferee whose basis becomes the fair market value of that asset will generate a tax to the transferor on the full amount of gain embodied in the asset. The payment of that tax should be adequate to deter tax motivated transfers. Thus we believe that the requirement that a transferee must acquire substantially all of the assets of the transferor for a transaction to be a qualified asset acquisition is not essential. In addition the rules respecting selectivity in asset and stock acquisitions could be greatly relaxed.

On the other hand if the General Utilities principle is substantially retained, the definitions of qualifying acquisitions seem reasonable and are certainly an improvement over existing law. However, if the General Utilities principle is retained, certain aspects of the proposals would undoubtedly require modification.

The Executive Committee supports replacing the rule of the Shimberg case with that contained in the proposal. We believe that testing dividend equivalency in reorganization transactions by reference to the shareholders' interest in the acquiring corporation accords with the fact that boot is typically provided by the acquiring corporation. Arguments in favor of this approach have been well made elsewhere and are noted in the Report. See, Levin, Adess & McGaffy, "Boot Distributions in Corporate Reorganizations - Determination of Dividend Equivalency," 30 Tax Law. 287 (1977).

Proposals For Limitations on Net Operating Losses

The Executive Committee generally believes that free transferability of operating losses is preferred to any set of rules that would restrict the transfer of losses in some cases and not in others. However, our observation of the public reaction to the safe harbor leasing rules suggests that this position is unlikely to gain wide-spread acceptance.

Because we favor free transferability of operating losses, we prefer the approach of Section 382(a) of existing law to the proposals contained in the Report. In general, Section 382(a) does not affect a corporation's net operating losses unless there is a transfer of a substantial interest in the corporation and the corporation discontinues the business being conducted at about the time of the transfer.

If Congress believes that it must adopt a rule which prohibits sales of losses, the proposals are more likely to achieve that goal than the rules of current law or those slated to become effective next year. The pool of capital approach underlying the proposals limits the allowance of losses to the income which the transferor of assets could have realized based upon the value of the assets transferred. Because the underpinnings of the two rules proposed are the same, we urge serious consideration be given to adopting only one rather than two rules. Specifically we recommend adoption of the rule denominated as the "purchase rule" because we believe it is simpler and more readily understandable.

Proposals For Distributions

The Executive Committee does not support the proposal for repealing earnings and profits as a limitation on distributions taxable as dividends. We believe that distributions which are in fact returns of capital should not be subject to the regular income tax imposed upon distributions of corporate earnings. To the extent such distributions exceed a shareholder's capital invested in the corporate distributor, the shareholder recognizes a capital gain which should be taxed as such. In addition we are concerned about whether the implications of this proposal have been thoroughly considered. We can foresee attempts by corporations attempting to take advantage of the proposal. In addition, it would still be necessary to compute earnings and profits in the cases of foreign corporations and affiliated corporations even if the proposal were adopted.

The Report lists several alternative proposals to complete repeal of earnings and profits. Each of these proposals seems directed at a particular situation. Of the several alternative proposals we are most troubled by the rules fashioned to tax as dividends distributions by corporations which have financial earnings but which do not have earnings and profits for tax purposes. We believe that the adoption of such a rule would have a significant effect upon the value of the outstanding shares of corporations affected by the proposal. In addition the ability of such corporations to raise capital by the issuance of shares could be adversely affected. We believe these dislocations require careful consideration before any such proposal is adopted.

The Report makes several suggestions in connection with consideration of the intercorporate dividends received deduction. One of those proposals is to deny such a deduction with respect to shares which are not held by the corporate distributee for at least one year. We assume that this proposal is prompted by a number of purchases of shares around the dividend record date which are held for sixteen days to avoid the restriction of Section 246(c). Although we understand that the 16-day rule of current law may be too short to prevent transactions based largely upon the dividends received deduction, we believe that a one year holding period is unnecessarily long to respond to concerns with these transactions. Mutual funds, public utilities and others will be unnecessarily, adversely affected by the proposal.

Proposal For Entity Classification

The Report suggests that limited partnerships with publicly traded partnership interests or instruments evidencing those interests should be treated as associations taxable as corporations. We recommend that the Committee defer consideration of this proposal. The proper treatment for tax purposes of firms organized as partnerships under state law has been considered many times by the tax writing committees of Congress and the Department of the Treasury. The issue is complex and involves the consideration of a number of factors. It is not clear to us what is inherently wrong with treating large, widely held partnerships as partnerships for tax purposes. To say that such organizations should be taxed as corporations if interests in such partnerships are publicly traded places a great deal of emphasis on a single factor.

In conclusion we believe that the Report raises a number of important questions and advances a number of thoughtful proposals. Because of the scope of these proposals and in view of our concerns with some of the specific proposals, we urge that they be given further consideration. We believe that the work of the Staff in preparing the Report is an important beginning to reforming the income taxation of corporations. We will continue to study the proposals in greater detail as the specifics of the proposals are developed, and we will, of course, be available to the Committee and the staff to assist in that development.

The CHAIRMAN. I would like to ask a few questions, if I might, to whoever would like to respond.

I think one of the criticisms we hear—and, again, maybe sometimes with justification; maybe this time, but one we are going to hear later this afternoon—is that we ought to study this a little longer. At least three of the four members of this panel made that criticism in regard to last year's changes. How do you feel about this year and this particular effort? How long have you been working on it now, I guess is the question. Did you say eight years, Mr. Andrews?

Mr. ANDREWS. The American Law Institute project began in 1974, in the summer of 1974, and continued with meetings through 1980, and then the report was published in 1982.

The CHAIRMAN. I think you have indicated, Mr. Delaney, that some areas may need additional study.

Mr. DELANEY. That is correct, Mr. Chairman. Now, if you come forward with a bill and the opportunity to study the specific provisions, then I don't know that it's a long-term 6-month or 1-year program; but a bill will be very helpful in concentrating the thought and study of the issue.

The CHAIRMAN. Well, that would be our hope, that we could put together a bill on a bipartisan effort or nonpartisan effort, introduce the bill, have additional hearings next year. But there are a few areas that we probably need to address this year. If we ought to tighten up somewhere without making broad changes, we ought to do that at the first opportunity, which hopefully will be yet this year.

But I think Mr. Battle has indicated there ought to be obviously time for public comment. Everybody who has an interest ought to at least know what is under consideration, or as many who can know what is under consideration.

Is it fair to say that you generally feel this area has had ample study?

Mr. TAYLOR. I think you have to distinguish between the areas. I concur with what Bill Andrews said on prospective merger and acquisition rules, and I think that can also be said with respect to net operating losses.

I don't know that there has been that kind of study in the earnings and profits area, which is a key production area, or with the treatment of limited partnerships as corporations.

The CHAIRMAN. In my opening statement I described the use of the dividends-received deduction to help finance a hostile corporate acquisition. I guess what I would like to know, based on what I understand about it, is: Does that go on very often? And is it a problem? Does it happen very often? Anyone on the panel may respond.

Mr. TAYLOR. I think it happens all the time. I think the problem with the calculations or the objection to the calculations that are made is that they don't take start with a pretax income of the target corporation and taking into account the fact that it may have paid tax on income that is represented by the $3 dividend cited in your figures.

The theory of the dividends-received deduction is that corporate income is taxed once and only once, which presumably happens at the target company level. The reason—that that goal could be accomplished a number of different ways.

Historically, we have accomplished the dividends-received deduction on the recipient side. It could also be accomplished by allowing a deduction for dividends paid by the corporation. That would be another way of doing it.

I assume the reason we have not done it that way is because of the great difficulty of identifying dividends that are paid to a corporation as opposed to dividends that are paid to an individual.

The CHAIRMAN. Can anybody else comment on that? Is there a problem there that we ought to be addressing?

Mr. ANDREWS. Well, Mr. Chairman, I would like to speak to that briefly, if I may. I need to preface this by saying that this question is not one that was taken up in any way in the American Law Institute discussions, except peripherally.

But I had the very strong sense that the dividend received deduction is a provision that makes a great deal of sense in the case of a continuing investment by one corporation in another, and very little sense in the case of a transitory or limited investment of one corporation in the shares of another; and that if a corporation is going to be permitted to act as an investor in the market, it ought to be taxed like other investors, and that means that dividends would be taxed more heavily, not less heavily, than other forms of return.

My own view is that this is one instance of the dividend received deduction operating in a way that is not consistent with its purpose, and that the staff proposal to impose a substantial holding period, in particular, is a very sound although ad hoc step to deal with that situation.

The Chairman. I think what we have done and the staff has done is to have gone through a number of the statements of other witnesses and visiting with other representatives who have an interest. They made certain criticisms which may be valid.

So I guess the next question is: We have heard that the proposals for limiting net operating loss have been criticized as too complex. Again, I am not certain who on the panel addresses that; but is that a fair criticism? I guess the next question is: If it is a fair criticism, how do we simplify it?

Mr. Delaney. Well, Mr. Chairman, we believe the 1976 amendments are really irrational, and we believe the proposals that have been made could be simplified, and we so testified on the House side. We believe you could cut it to a one-prong test rather than a two-pronged test and hence simplify considerably the outcome.

The basic thrust of the proposals we totally agree with.

The Chairman. Would anybody else comment on that?

Mr. Taylor. Well, I think the criticism of the proposed rule as being too complex proceeds from the assumption that one rule is automatically quantum-better than two rules. I guess we are unpersuaded on that, that you could not have two rules work well and simply, and that, therefore, you ought to sacrifice the better merger rule in order to have a single purchase rule.

The Chairman. Can anybody respond to the criticism that the shareholder credit, which the Treasury has now recommended, is too complex? Can anybody give any thought to that particular area?

Mr. Andrews.

Mr. Andrews. Yes; I think that the complexity recognized in the shareholder credit is something of a problem, but that it is more a matter, I think, of unfamiliarity than unmanageable complexity.

My own judgment would be that if the committee is favorably impressed by the effects of a credit, that that would be quite a manageable kind of computation.

The Chairman. Mr. Delaney, I think you have given an answer, but how would you counsel us to proceed with this project? What is the ABA tax section going to do? What is your next step?

Mr. Delaney. Mr. Chairman, are you referring to the total project?

The Chairman. Right.

Mr. Delaney. We are more than prepared to work with the staff in further developing it. Our understanding of the timeframe was a bill sometime within the next month or two, further hearings, and then possible hearings on the House side on a similar measure. We are in full support of that.

I have appointed a separate task force, separate and apart from the working group, to study this and help develop section positions on each of these proposals.

As you know, we work under very, very strenuous limitations—speaking on behalf of the American Bar Association. But we think that the program that has been indicated to us as a goal would be very workable, and we are prepared to move ahead with it and bring people here to help your staff and the joint committee staff and the House staff to develop these proposals into a bill.

The CHAIRMAN. I have a number of other questions, and most of them are based on statements we are going to have from other witnesses. I am not certain that we can't have you respond in writing, if you would be willing to. It might save the time of other witnesses, and we may bring out questions as we deal with other witnesses.

As you know, we are now just discussing the report. There is no legislation before the committee. We are not attempting to report out any legislation; we are just at the initial hearing on what we consider to be a worthwhile project.

Hopefully, we will have a bill introduced but probably not before we leave, assuming we leave on November 18th, as was the schedule last week. It could be changed because of other events.

We appreciate very much not only your testimony but your willingness to continue to assist us and your past assistance. Thank you very much.

Our next panel consists of Donald C. Alexander, Esq., Morgan, Lewis and Bockius, Washington, D.C.; Robert A. Jacobs Esq., Milgrim Thomajan Jacobs and Lee, New York, N.Y.; and John S. Nolan, Esq., Miller and Chavalier, Washington, D.C.

Don, are you going to start?

Mr. ALEXANDER. I would like to start, if I could, Mr. Chairman——

The CHAIRMAN. Sure.

Mr. ALEXANDER [continuing]. Because I am on Secretary Watts' Coal Leasing Commission. We have a hearing in Denver tomorrow, and I have to show up at that.

The CHAIRMAN. Good. Well, you can start right now—either here or for Denver. [Laughter]

STATEMENT OF DONALD C. ALEXANDER, ESQ., MORGAN, LEWIS & BOCKIUS, WASHINGTON, D.C.

Mr. ALEXANDER. I know that many in the room would prefer the latter, of course, but I would appreciate the former.

I certainly hope you proceed with the project and don't let it die.

Subchapter C is badly flawed; it's badly in need of revision, and reform is overdue. And the time is now. The ALI project is an excellent place to start, and staff has done a fine job of putting together a report that contains many sound recommendations.

Turning briefly to the points on which you specifically asked for our views, Mr. Chairman, I think that some relief should be given if you are going to repeal General Utilities completely—particularly where there is a complete liquidation of a small corporation. You are going to hear a lot more about that from other witnesses. I don't think that you ought to let that particular problem prevent the project from going forward, because I am convinced that relief can be crafted. It will work.

As to the preferred-stock gambit that you mentioned, it needs correction. You can correct it two ways. One would be to disallow the short-term capital loss, and I discuss this problem in my statement.

Earnings and profits? Getting rid of that is a really drastic step, and maybe you ought to try to fix it up before you dispose of it.

On net operating losses, I think there is much to be said, as long as we are going to have ACRS in the law, for permitting benefits to go to the poor as well as to the rich. And the more you cut back on the transferability of net operating costs, the more you confine them to the rich.

Finally, on partnerships, the problem there is that some bad regulations were written back in 1960, converting associations into partnerships. It's too late to correct them, but at least for the future—being fair to everybody who is now treated as a partnership out there in the public—I think that area needs correction along the lines in the staff report.

[The prepared statement Donald C. Alexander follows:]

STATEMENT OF
DONALD C. ALEXANDER
BEFORE THE
SENATE FINANCE COMMITTEE
UNITED STATES SENATE

October 24, 1983

My name is Donald C. Alexander and I am a partner in the law firm of Morgan, Lewis & Bockius. I am appearing here today solely in my personal capacity and not on behalf of my law firm or any client, although of course I have interests in various issues raised by the Staff Report.[1.] I participated in an informal working group which assisted the Staff.

I. NEED FOR REFORM

It is extremely improbable that any of the witnesses here today support all the Staff's recommendations. Nevertheless, most of us would agree that there is much merit in the Staff Report. Most of us would agree that present Subchapter C of the Internal Revenue Code is seriously flawed, is filled with inconsistencies, disguised opportunities and hidden traps, and should be thoroughly reviewed. The Staff has made such a review and has performed a substantial public service in its examination and recommendations.

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1. The Reform and Simplification of the Income Taxation of Corporations, a Preliminary Report prepared by the Staff of the Senate Committee on Finance (September 22, 1983). (Staff Report)

The Staff has utilized work undertaken by others over a long period of years, particularly that of the American Law Institute embodied in its definitive study, Federal Income Tax Project: Subchapter C (1982).

Despite the discomfort that change creates, particularly to practitioners who have an economic stake in existing law, we need to correct existing law. But change should be made carefully and deliberately, with recognition of the fact that irrevocable investment decisions have been based on present law.

I believe that, in general, the Staff's recommendations with respect to the treatment of corporations and shareholders in acquisitions would substantially improve existing law. Moreover, repeal of the remaining vestiges of the *General Utilities* doctrine is a sound objective and would solve many vexing problems. However, it should be tempered as suggested below.

I hope that this project will not die after this hearing. Present Subchapter C, with its trappings like Code Section 269, is seriously defective; the Staff Report and the hearing today should be early parts of a continuing process, to be completed next year, of basic revision and reform.

II. RESPONSES TO SPECIFIC QUESTIONS

My views on the specific questions on which Chairman Dole requested comment are as follows:

1. *Taxation of Gain on Distribution of Appreciated Property*. Repeal of what is left of the *General Utilities* doctrine, thus calling for the recognition of gain on corporate distributions of appreciated property, whether or not in liquidation, is a desirable but drastic step. Acknowledgement of the latter attribute led the Staff to suggest a slow phase-in of capital gains taxes.[2.]

Other solutions include a shareholder credit for the tax paid by the corporation, or a reduction of such tax, or exemption from or deferral of tax on certain types of assets. While each of these solutions presents definitional and administrative problems, I have a slight preference for a shareholder credit along the approach suggested by the American Law Institute.[3.]

(2) *Dividends Received Deduction on Short-Term Preferred Holdings.* The Staff Report describes a gambit presented by present law for securing short-term capital losses and the dividends received deduction. This problem should be addressed and solved, but there can be reasonable differences over the scope and method of its solution. Since in economic reality no loss has been sustained in the example addressed by the Staff, disallowance of the loss is an obvious candidate for its solution. However, the Staff's approach is to deny the dividends received deduction unless the stock in question is held for one year and to cope with the tax arbitrage opportunity

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2. See page 66, Staff Report.

3. ALI, *Federal Income Tax Project: Subchapter C* (1982), pp. 134-141.

afforded by the interplay between the interest deduction and the dividends received deduction. I do not quarrel with the Staff's approach of the alternative course of requiring a longer holding period, but I suggest that the requirement be limited so as to cover fully the abuse situations (e.g., stock traded on an established securities market and certain preferred stock, whether or not actively traded) without being applicable to clearly non-abuse instances. Secondly, Section 265 of the Code, disallowing expenses and interest allocable to tax-exempt income, has not worked well in practice. If this provision should be extended to cope with the tax arbitrage problem mentioned above, it should be amended to substitute arbitrary but administrable standards for present uncertainties.

(3) Earnings and Profits. One of my first assignments when I started practicing tax law in 1948 was to determine earnings and profits of a substantial and complex corporate group which had begun its existence in the 19th century. Quickly I became convinced that the determination of earnings and profits is a mystery never to be revealed to mortals, and little has happened in the ensuing 35 years to alter this view. You need to eliminate the concept or to define earnings and profits in a definitive and administrable way. The Staff proposes to eliminate the concept of earnings and profits for Subchapter C purposes while retaining it for

other purposes such as the computation of the foreign tax credit. I suggest that before adopting this course, Congress give further consideration to (1) solving the abuse situations cited by the Staff through statutory and regulatory changes and (2) determining whether a rational and workable definition of earnings and profits may be devised so that the concept may be retained and we may avoid a new set of problems, discussed by others, which would be created by its elimination.

(4) Net Operating Losses. In 1981 massive tax incentives, largely in the form of ACRS allowances, were added to the Code. Because of a sluggish economy, particular problems in particular industries (e.g., steel, airlines), and the effect of recent statutory changes, many corporations have substantial operating loss carryovers. By no means are all of these losses due, as the Staff Report suggests, to economic inefficiencies. When it enacted these incentives in 1981, Congress refused to limit them to the rich and deny them to the poor; safe harbor leasing accompanied ACRS to assist those who wished to acquire productive plant and equipment but could not currently utilize tax benefits to realize upon such benefits by transferring them to others. Since safe harbor leasing is no longer with us and ACRS and the credits remain, we should not further reduce opportunities for those with tax losses to benefit from them. The New York State Bar Tax Section was correct, I think, when it stated in 1982: "We believe there is much to be said, therefore, for free

trade of stock of corporations having net operating loss carryovers,"[4]

Therefore, I question the desirability of proposed new limitations, based on a "pool of capital theory", which would reduce the transferability and value of loss carryovers.

A particular problem is presented when a loss corporation (of which there are many) attempts to rehabilitate itself through acquisitions. Is it in the public interest to deny such a corporation the right to utilize its full losses against its full income? Unlike the apparent thrust of a companion proposal now before the Ways and Means Committee[5], the Staff Report provides limited relief to a loss corporation seeking to rehabilitate itself by rendering its new merger rule inapplicable if the shareholders of the loss corporation continue to own 80% or more in value of the loss corporation stock. This is a helpful but inadequate step; a loss corporation should not have the value of its carryover reduced by a merger or similar transaction if its shareholders retain more than 50% of the stock of the combined enterprise.

Despite the fact that the current provisions of Section 382 of the Code are scheduled to be replaced in 1984 by the long-deferred and unsatisfactory 1976 version, there is no need to craft a hasty replacement which contains the seeds of overkill. The Republic will survive if present law is extended again for a time.

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[4] New York State Bar Association Tax Section Committee on Corporations, Report on Section 382 of the Internal Revenue Code, as amended, by the Tax Reform Act of 1976, 31 Tax Lawyer 283, 286 (1978).

[5] See Joint Committee on Taxation, Description of Proposal Relating to Special Limitations on the Carryover of Net Operating Losses and Other Tax Attributes of Corporations (September 21, 1983).

(5) Corporate-Type Limited Partnerships. I believe that limited partnerships with publicly-traded partnership interests should, in general, be considered associations taxable as corporations under Section 7701(a)(3) of the Code. This has been my personal view for more than 20 years, since I testified against adoption of the present classification requlations.[6.] These regulations are the source of the problem; designed to thwart physicians who sought equity in pension planning (a goal secured by court decisions and later by legislation), they failed in their purpose but instead succeeded in permitting what are truly associations to be misclassified as partnerships with all attendant conduit benefits. It is too late to correct the mistake made in the 1960 Regulations, but it is time to remedy this long-festering problem by legislation. Subject to fair and reasonable transitional rules which recognize economic and investor realities created by the Regulations, giant publicly-traded entities which now masquerade as partnerships should be taxed as corporations.

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6. Reg. Sec. 301.7701-1, -2, and -3 (1960).

The CHAIRMAN. Well, I appreciate your being here, Mr. Alexander. You are probably on the 4:40 flight; is that correct, if you are going to Denver? My wife happened to be on it yesterday. If you are going to Denver, you may have to leave at 4:40.

Mr. ALEXANDER. If so, I'm in deep trouble. [Laughter]

The CHAIRMAN. Right. That's why I thought if that was the flight, I would excuse you now.

Mr. ALEXANDER. I'm on a later one; not being in Government any longer, I have more of a transportation problem than the Secretary. [Laughter]

So I can hang around while my two friends have their statements, if they are equally brief. [Laughter]

The CHAIRMAN. We will have Mr. Jacobs and then Mr. Nolan.

STATEMENT OF ROBERT A. JACOBS, ESQ., MILGRIM THOMAJAN JACOBS & LEE PROFESSIONAL CORP., NEW YORK, N.Y.

Mr. JACOBS. Thank you, Mr. Chairman.

Some 25 years ago Judge Tuttle asked me what I would do if I somehow got the scholarship that I was applying for that he was about to bestow on somebody. I said I would make the tax law better, or at least I would try, and he said, "How would you do that?" I said, "I would have the temerity to try to come to Congress and do something about it." It has taken me a long time—not quite as long as this bill, perhaps,—to get here.

These past few months we have been working with your staff under the leadership of Andre LeDuc. We have worked hard in what has been the most rewarding professional experience in my lifetime—working with material that is difficult, working with people that are dedicated, and working with ideas that are true, to produce a proposal, a series of ideas, answers to some difficult questions. I think that a great service has been done for the Congress and for the country in bringing forward these intelligent proposals.

Like Don, I don't agree with all of the details. My reservations are set forth in my testimony. But what I do know is that the time is now, the problems are real, the corporate tax law cries out for correction. I don't think that we can, with a straight face, continue much longer to allow the existing problems to continue.

There are answers, and we can find them. And the answers can be simple, the answers can be certain, and the answers can be fair.

Thank you.

[The prepared statement of Robert A. Jacobs follows:]

STATEMENT OF ROBERT A. JACOBS
MILGRIM THOMAJAN JACOBS & LEE PROFESSIONAL CORPORATION

I am Robert A. Jacobs, a member of the New York City law firm of Milgrim Thomajan Jacobs & Lee Professional Corporation. I am an adjunct professor of law at the New York University School of Law, teaching a seminar entitled Advanced Corporate Tax Problems and serve as chairman of the American Bar Association Tax Section's Committee on Corporate Stockholder Relationships and chairman of the New York State Bar Association Tax Section's Personal Income Tax Committee. I appear today on behalf of no client and do not represent the views of any organization with which I am affiliated.

During the past ten months your staff has worked with academicians and practitioners to shape the proposals you are today considering. These proposals seek to comprehensively address, redress and rationalize the complexities, incongruities, inconsistencies and vagaries of our present scheme of corporate taxation. The proposals, in large measure, are drawn from the recommendations of the leading tax organizations and writings of respected commentators over the past thirty years. They result from thoughtful analysis of divergent views and concerns. They represent the very best thought on this important and vital subject.

I urge that we not let this opportunity to fix the corporate tax law escape. One of your staffers observed that this subchapter C project has been far more "labor intensive" than anyone anticipated. The thousands of hours invested by your staff and its volunteers in this project will deter all but the most dedicated from trying to soon revive it, if it fails enactment by the 98th Congress. Corporate tax law is too complex and the concerned constituencies too small to muster often the requisite legislative effort. The program has been set in motion; the corporate tax provisions are ripe for reform. I urge you to act on these proposals and bring simplicity, certainty and fairness to our corporate tax law.

My support of the staff's subchapter C project and my urging that the Internal Revenue Code's shortcomings in the field of corporate taxation be addressed and resolved are not an endorsement of all the views expressed in the Preliminary Report. Some of my exceptions are noted below. But those reservations do not detract from my unqualified endorsement of the thesis of the Preliminary Report, i.e., present corporate tax law is unduly complex, unpredictable and in need of immediate structural, philosophical and technical improvement.

A good corporate tax law should have sound philosophical underpinnings, be reasonably certain in its application and not unreasonably complex. Our present corporate tax structure avoids each of these criteria splendidly. The admonition that "if it ain't broke, don't fix it" is not controlling here; our corporate tax vehicle is broke and must be fixed -- soon. A few moments of reflection confirms this perception.

Corporate reorganization provisions that treat essentially similar transactions as either taxable exchanges or tax-free exchanges, depending upon distinctions that inventors of parlor games would have trouble justifying, should not be permitted to continue. Why should taxation turn on whether a merger is effected by merging T into PS, rather than PS into T? Why should a lot of cash be o.k. in an (A) reorganization; a little cash o.k. in a (C) reorganization and no cash o.k. in a (B) reorganization? The inconsistencies and anomalies of the reorganization provisions are recounted in detail in the Preliminary Report. If anything, they are understated. The ABA Tax Section made a partial pass at correcting some of the most obvious shortcomings in the reorganization definition. See ABA Tax Section Recommendation No. 1981-5, 34 Tax Lawyer 1386 (1981) and Jacobs, Reorganizing the Reorganization Provisions, 35 Tax L. Rev. 415 (1980). The ABA left much undone. The Preliminary Report undertakes to complete that task with distinction. That is not to say that the proposals embodied in the Preliminary Report are perfect or even practically perfect. They should be recognized for what they are -- thoughtful, practical solutions to difficult problems.

To be effective the corporate tax law must be simple, certain and fair. Indeed, simplicity and certainty foster fairness. If we can achieve simplicity and certainty, substantial fairness will be automatically injected into the system. Take for example the problem of net operating loss carryovers. The "fairness" we seek is "neutrality", i.e., the loss corporation, in the hands of its new owners, may use its net operating loss carryovers to the same extent, as to both amount and timing, as it could have used them had there been no change in ownership and had the loss corporation invested its assets in income generating activities. But once the neutrality assumption is accepted and its principles become the theme of the remedial legislation, neither simplicity nor certainty should be sacrificed by blindly following the neutrality notion wherever it may lead. We should keep in mind that the neutrality princip~~al~~le, however well formulated, is nothing more than a convenient fiction. Indeed, corporations themselves and the entire corporate tax structure are legal fictions. Those fictions are helpful -- so long as we remember that they are fictions, not scientific truths or religious precepts. Rather than adhering to the theoretical formulae of the neutrality principle set forth in the Preliminary Report, the testimony on this subject before Congressman Stark's subcommittee on September 22, 1983 should be heeded. A "purchase price" limitation on net operating loss carryovers can effectively approximate the neutrality rules proposed in the Preliminary Report, without their attendant uncertainty and complexity. Spreading that loss utilization availability (properly "grossed up" to say 125% of the purchase price) over five years would achieve all three goals of simplicity, certainty and fairness.

I comment briefly on the five specific proposals outlined in the October 4 press release.

1. Relief from gain recognized on liquidating distributions of property and cost basis acquisitions. To bring some semblance of order to subchapter C, the Preliminary Report recommends overruling *General Utilities*.* That long overdue step may unfairly surprise shareholders of corporations that own appreciated capital gain property.

Example:

> *A* incorporates *T*, transferring to it his corner grocery business. One of the incorporated assets is a building that houses the grocery, adjusted basis $100, fair market value $1,000. Six years later *A* liquidates *T* and receives back his former business, including the building. The building now has a zero basis and a fair market

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* *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

> value of $1,200. A is taxed on the gain he realizes in the liquidating distribution. Should T be required to recognize $1,200 gain (presumably all Code §1231 gain) on distributing the building in complete liquidation?

In a two-tier tax regime, there is no theoretical justification for relieving T from tax on the sale or distribution of appreciated property. [For that matter, there is no theoretical justification for not taxing A when he transfers appreciated property to T, but the Code §351 tax-free incorporation policy overrides the theoretical purity of the two-tier taxing regime.] Nonetheless, the long history of not taxing this gain, particularly on the "death" of the corporation, *i.e.*, upon its liquidation, should not be ignored. Most of the suggested relief measures properly focus on T's long-held capital gain property. The American Law Institute's shareholder credit proposal; the phase-in tax proposal of the Preliminary Report; and the deferred gain recognition proposal, all limit their relief to capital gain property.

I favor exonerating long-held (*e.g.* three years or more) capital gain property, including Code §1231 property, from the *General Utilities* tax. I appreciate that there is no theoretical reason compelling this approach; nor, for that matter, any other relief measure. Yet, the history here is so compelling that taxing this gain just seems wrong. Besides, I see no reason to galvanize opposition to the entire subchapter C revision by permitting citation to a fundamental change in law that would impose a "new" tax on a sympathetic shareholder who receives appreciated property liquidating distributions from her corporation. If Congress recognizes the desirability of overruling General Utilities in all cases, save those involving long-held capital gain property, an acceptable statute can be drafted that can gain wide support from a cross section of tax specialists and concerned corporate taxpayers.

2. The 85% dividends received deduction. Under present law, corporations may borrow funds to purchase or carry dividend paying portfolio stock. If the dividends on the portfolio stock equal the interest carrying costs, the results are most happy indeed -- at least for the corporate investor. The following example compares the profitability of this enterprise under existing law and under the Preliminary Report, assuming the taxpayer's debt to equity ratio is 1:1.

	Existing Law:	Proposed Law:
Dividend Income	$100.00	$100.00
Code §243 deduction	85.00	85.00
Taxable income	15.00	15.00
Tax rate	.46	.46
Tax	$ 6.90	$ 6.90
After-tax dividend proceeds	$ 93.10	$ 93.10

Interest deduction	$100.00	~~$ 42.50~~	† 57.50
Tax rate	.46	.46	.46
Tax saving	$ 46.00	$ 19.55	26.45
After-tax interest cost	$ 54.00	$ 80.45	73.55
After-tax dividend proceeds	$ 93.10	$ 93.10	93.10
After-tax interest cost	54.00	80.45	73.55
Net profit from transaction	$ 39.10	~~$ 12.65~~	† 19.55

The result under existing law seems too good to be true. A 100% debt finance investment that produces a zero economic return yields a $39.10 after-tax profit. The proposed amendment to Code §265(2) would effectively remove the incentive to purchase debt financed dividend paying portfolio stock. Under the Preliminary Report, assuming the corporate taxpayer has $10,000 of equity and $10,000 of debt, 50 percent of all portfolio investments would be deemed debt financed. Thus, the interest deduction attributable to the dividend paying stock would be reduced from $100 to $~~42.50~~ 57.50, reducing the net after-tax profit from $39.10 to $~~12.65~~ 19.55. This result seems right, especially when the focus is on the corporate taxpayer that receives the leveraged dividends.

I recognize that the conclusion may be otherwise if the transactions are viewed in a broader perspective. Traditionally we have not exacted a full tax on intercorporate dividend payments. Arguably, where the corporate payor claims no deduction, the corporate payee should not be required to include the payment in its income. This construct permits the transfer of tax benefits from loss corporations to profitable corporations, transfers which you may view as entirely appropriate or thoroughly unacceptable. If those transfers are to be encouraged, leveraged stock purchases by corporate investors are not an abuse. Rather they are consistent with a policy that taxes corporate income only once, so long as it remains in corporate solution.

The other proposal extends the minimum holding period for stock on which the 85 percent dividends received deduction is available from 15 days (or in some cases, 90 days) to one year. This is a salutary improvement that should be enacted.

3. Earnings and profts as a dividend measurement. There is, to my mind, little doubt that the earnings and profits concept is a poor measure of dividend treatment. Non pro rata redemptions and distributions of funds borrowed against appreciated property owned by the distributing corporation, to mention but two obvious examples, distort dividend treatment. The Corporate Stockholder Relationships Committee of the ABA Tax Section has begun a study of the earnings and profits concept and how it might be eliminated from the Code. The implications are significant; until those implications are understood I remain uncertain whether a piecemeal repeal of earnings and profits as a dividend measure, as recommended, would be an appropriate first step or an undesirable half effort that would hinder com-

prehensive reform. Any legislation in this area must take into account its effect on intercorporate dividends. By increasing the dividend component of intercorporate payments, if the 85% dividends received deduction is retained, corporate shareholders may be able to substantially reduce their taxes on intercorporate distributions.

Some corporate taxpayers rely upon the earnings and profits measure to make regular nontaxable distributions, making their stock attractive to purchasers. Corporations in the extractive industries and public utilities may be adversely affected by the proposed legislation. If so, Congress should consider fashioning an exemption for them, rather than shelving an otherwise desirable reform.

4. Net operating losses. As I observed in my general remarks, net operating loss carryovers can and must be legislated with an appreciation of the possible. Legal theories should give way to an intelligent amalgam of simplicity, certainty and fairness, which can be achieved without subjecting taxpayers to purchase rules and merger rules; varying assumed rates of return; and tabular computations of income available for net operating loss offset. Each uncertainty introduced into the system perpetuates the advantage prospective buyers now wield over prospective sellers of net operating loss carryovers. Where the "going rate" for NOLs is 10 percent and their value to the buyer is 46 percent, the Treasury pays a dear price

for that uncertainty. Neutrality can be approximated and the tax system can be bettered if a single modified purchase price rule is enacted.

5. Should publicly traded limited partnerships be taxed as associations? This issue is not central to the other concerns covered in the Preliminary Report. That publicly traded limited partnerships have corporate characteristics is not new or novel. How existing and future publicly traded limited partnerships should be taxed -- particularly in the new world envisioned in the Preliminary Report -- is not an easy question. I should think this issue could best be handled by postponing a decision now, looking at the problem anew in light of the new legislation when it is enacted.

* * *

Under the Preliminary Report proposals the collapsible corporation provisions can be excised from the Internal Revenue Code, both for foreign and domestic corporations. What a marvelous blow for simplicity! The consistency rules of Code §338 can be junked; another strike for simplicity, certainty and fairness. The reorganization provisions can be rationalized -- perhaps for the first time ever. With these prospects at hand, it would be most unfortunate to permit other concerns, however worthy, to delay or end this reform process. That is not to say that all that is before you is perfect. Rather, the question is whether the legislation suggested in the Preliminary Report provides a comprehensive core of a new corporate tax law; one that can be built upon with the inevitable corrections and the hoped for improvements to make our corporate tax law better; a tax law that approaches fairness, certainty and simplicity. We may never achieve all our goals, but we should never stop trying. These proposals are a giant step forward. I feel privileged to have played a small role in their development and commend them to you with confidence that their enactment will vastly improve our corporate tax system.

STATEMENT OF JOHN S. NOLAN, ESQ., MILLER & CHEVALIER, WASHINGTON, D.C.

Mr. NOLAN. Thank you, Mr. Chairman.

I am John S. Nolan, a tax lawyer in Washington, D.C. I confine my remarks this afternoon to the subject of the General Utilities rule. And, while I hate to be the first to sound a discordant note in this love feast, that's precisely what I am going to do.

I appear today for a group of privately held companies that would be severely harmed by the staff proposal to repeal the General Utilities rule with respect to complete liquidations of corporations. This proposal would impose a double tax on the appreciation in value of corporate assets which are sold or distributed in a complete liquidation. This would effectively raise the capital gain rate on this element of gain from investment in corporate business from 20 percent to 42.4 percent.

The impact will be almost entirely on closely held family businesses, large, publicly held companies seldom undergo complete liquidation. This is neither an efficient nor a fair tax increase, and I recommend strongly against it.

The family businesses I represent typically hold a wide range of business assets, including real estate from which their manufacturing or wholesale or retail business may be operated. They also include family companies which hold real estate which has been collected and developed over a long period of years and is leased to third parties. These family corporations have paid full corporate income tax on their earnings, perhaps through several family generations. The assets are likely to have appreciated substantially in value over a long period of years, in large part as the result of inflation. The family business may have developed patents, trademarks, trade secrets, a trade name, know how, goodwill, or other intangible asset values which have appreciated greatly in value. This is a typical pattern in many of our high technology companies.

These families have operated their business through a family corporation based on certain fundamental assumptions as to our taxing system as it has operated for the last 50 years. As I have said, they have paid a full corporate income tax on their regular earnings, they have also paid a second shareholder-level tax on any such earnings distributed as dividends. Our system has not required them to pay a double tax on retained earnings reinvested in the business. Furthermore, and what is critical in the present context, our tax system has provided that they would pay only a single capital gains tax on the appreciation in value of the underlying assets in their business upon selling or otherwise completely liquidating their business.

The proposal in question would change this latter treatment. It would impose a double tax on the appreciation in value of the underlying assets of the business, representing gain which may be largely inflationary gain. The tax cost of a decision to terminate the family's interest in their business, selling the assets and completely liquidating the corporation, or selling the stock, as I have said, would be effectively increased from 20 percent to 42.4 percent with respect to their gain attributable to the appreciation in value of the underlying corporate assets.

In the short run, the result would be to bias the decisions of these families in favor of merging their family companies into large publicly held companies in a tax-free exchange for stock of the public company. Public companies with tax losses created by ACRS deductions or otherwise, or with unused investment tax credits, will aggressively seek to acquire such privately held companies. This will interfere with the allocation by such families of their capital to its most efficient uses in the market.

In the longer run, privately held business may seek to avoid incorporation. Our capital markets, the largest and most efficient in the world, are based on financial instruments of corporations, not unincorporated businesses. These markets will adjust, but possibly at a significant cost to the capital formation process.

Mr. Chairman, there are major economic, legal, and social considerations involved in creating a bias through our tax system to operating businesses through partnerships or other unincorporated forms, and in creating additional tax burdens on privately held business.

These issues require more thought and analysis before we decide to impose a double tax burden on extraordinary gains in underlying asset values in the complete liquidation of corporations.

[The prepared statement John S. Nolan follows:]

STATEMENT OF JOHN S. NOLAN
SENATE COMMITTEE ON FINANCE
OCTOBER 24, 1983

REFORM OF CORPORATE TAXATION

I am John S. Nolan, a lawyer in private practice in Washington, D.C., specializing in corporate tax law for more than thirty-two years. I have also taught Advanced Corporate Taxation in the Adjunct Program at the Georgetown Law School at various times in past years. I appear today for a group of closely-held businesses that would be severely harmed by the proposal in the Committee Staff's report of September 22, 1983, to repeal the General Utilities rule with respect to complete liquidations of corporations.

Corporate Tax: Asset Appreciation on Complete Liquidation (General Utilities)

The result of the Staff proposal as to the General Utilities rule would be to impose a double tax on the appreciation in value of corporate assets sold or distributed in the course of a complete liquidation. This would effectively raise the maximum capital gain tax on this increase in asset value from the 20% rate, applicable to all other capital gains, to 42.4%. Gain is already taxed on such increase in asset value to the extent of -- (1) depreciation or ACRS deductions previously taken; (2) a company's "LIFO reserve"; and (3) a variety of so-called tax benefit items. (The investment tax credit is also subject to recapture.)

The additional gain that would be taxed by the proposed repeal of General Utilities would in many cases be largely inflationary gain, not real gain, together in some cases with the value of intangible assets of the business. A tax rate of 42.4% on these kinds of gain is not justified.

The impact will be almost entirely on closely-held family businesses; large publicly-held companies very seldom undergo complete liquidation. The short-term result will be to bias the decisions of these families in favor of merging their family companies into large publicly-held corporations in a tax-free exchange for stock of those companies, rather than allocating their capital to other uses that could be more efficient. The tax law would thus further interfere with market allocation of capital.

In the longer run, business will tend to avoid incorporation wherever possible. Our capital markets, the largest and most efficient in the world, are based on financial instruments of corporations, not unincorporated businesses. These markets will adjust, to be sure, but at a significant cost to the capital formation process. New instruments subject to new dimensions of risk will be required to replace corporate capital instruments.

As a lawyer experienced in this field, and as a former law teacher of the subject matter, after taking into account the circumstances of my clients and others similarly situated, I strongly oppose this particular element of the

Staff's report. While I agree with many of the other major elements of the report, and while I see no strong objection to repeal of the *General Utilities* rule in the case of *ordinary* distributions in kind, I think that its repeal with respect to *complete liquidations* would be a grave error in tax policy.[*] I have studied the detailed reasons given for its repeal in the Staff report, and I do not find them convincing. They proceed from a fundamentally erroneous premise and are based far too much on unjustified speculation. The reasons given against repeal are understated and require much further development.

I note that in recent letters to Senator Dole, two prestigious bar associations with great experience in this field, the Association of the Bar of the City of New York and the Tax Section of the New York State Bar Association, have singled out this same matter to urge further careful evaluation. I strongly urge this Committee to exercise great caution in making such a fundamental change in our corporate tax structure.

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[*] I recognize that repeal of *General Utilities* is a key element in the major treatment of acquisitions proposed in the report -- that is, the election between cost basis and carryover basis treatment at the corporate level and the separate tax treatment at the shareholder level. If *General Utilities* is not repealed in the corporate liquidation context as I recommend, it will be necessary to retain the basic elements of §§337 and 338; it obviously is not desirable to return to the uncertainties of *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) versus *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950), and *Kimbell-Diamond Milling Co. v. Commissioner*, 187 F.2d 718 (5th Cir. 1951). If the acquisitions proposals are adopted, but *General Utilities* is not repealed in the complete liquidation context, recapture should be required, but gain or loss should not otherwise be recognized, in transactions generally of the type described in §337 and §338 if the acquiring company elects cost basis treatment. The operation of those two provisions could be improved and restricted to their true purpose. It may be that recapture should be required in any such case, whether the acquiring corporation elects cost basis or carryover basis treatment. These are matters which require a great deal more study.

Impact of the Proposed Change -- Family-Held Businesses

As previously stated, by far the greatest impact of the proposed change will be on family-held businesses. These family businesses typically hold a wide range of business assets, including real estate from which the business may be operated, or real estate collected in a family investment company. These assets are likely to have appreciated substantially in value over a long period of years, in large part as a result of inflation. The business will often have developed patents, trademarks, trade secrets, know-how, or other valuable intangible assets. Many family companies have been operated through several generations, thus greatly increasing the inflationary components of these gains. The proposal will tax all of this gain at the corporate level, in addition to the same gain being taxed again at the shareholder level, on complete liquidation of the family company.

Even though the family company may have been operated for many years, the family may have become so large, or the interests of different family members may have become so diverse, that it may make greater economic sense for the family to liquidate the corporation, possibly selling all or part of its assets, or to sell their stock, and undertake other business ventures. It may have become economically more efficient for third parties to acquire the business. There are a wide range of reasons why it may become appropriate for the family to terminate the activities of their corporation by complete liquidation. These families have operated on certain fundamental assumptions as to our taxing system as it has existed at least for the last fifty years, even prior to the time the General Utilities case was decided in 1935. These include a clear understanding under our tax system that upon a decision to terminate their business and completely liquidate, they could do so incurring only a single capital gains tax on such a terminal transaction on the appreciation in value of the underlying assets of the business. This has been the case whether they sell the assets of the business to third parties, divide the business among themselves while it remains in corporate solution, or take their respective shares of the assets in kind and operate as sole proprietorships or partnerships.*

In any such case, they seek to put their capital to its most effective uses in our economy. A single capital gains tax on this terminal transaction, just as if the gain had arisen from any other investment asset held by them, is entirely appropriate. As previously stated, much of the gain is probably inflationary gain, not real gain, and thus deserves only a single capital gain tax. Even the balance of the gain, likely to be largely attributable to real estate or intangible assets,[*] is by nature essentially an investment gain, not income attributable to regular business activity that typically is taxed at higher rates. The gain in question by its nature is capital gain. It should attract only a single capital gain tax.

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* See United States v. Cumberland Public Service Co., supra, IRC §337; IRC §355 and its predecessor in the 1939 Code; IRC §336.

A capital gain tax of 42.4% on this gain is not justified. The result will be that families wishing to terminate their family businesses will effectively have only one option -- find a publicly-held corporation and take its stock for their company. A publicly-held company with tax losses created by ACRS deductions or otherwise, or with otherwise unusable investment tax credit, could presumably elect to step-up the basis of the assets at the corporate level in a cost-basis transaction under the other proposals in the report at minimal tax cost.

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[*] I recognize that the report (pages 58, 61) provides that in a cost basis acquisition, unallocated acquisition premium (goodwill) will not be taxed at the corporate level but will be given a carryover basis. This does not solve the problem as to intangible assets other than goodwill, such as patents and trademarks, and may create new controversies as to what is goodwill -- for example, whether know-how, trade secrets, trade names, or the like are to be treated like patents or trademarks, on the one hand, or as part of such "unallocated premium" on the other hand. Further, the acquiring company, having paid for such values, may discount their value for the absence of a stepped-up basis since they may be sold by it in the future. If so, the shareholders of the target still bear an implicit tax burden at the corporate level. Finally, the treatment of such goodwill value in complete liquidations involving distributions of the assets in kind is not dealt with in the report. If the parties seek to operate their business as a partnership, and if the value of such asset would be taxed at the corporate level in the absence of §336, the parties could be forced to sell their business to others or find some other way to avoid double tax on such asset value.

While the report is not explicit on the point, the family would apparently lose the opportunity to divide up businesses in corporate solution either in a pro rata or non pro rata spin-off by causing the parent corporation to distribute the stock of its subsidiary to some or all of the family shareholders without tax. This has proven to be a very healthy and efficient alternative for the continued operation of privately-held businesses. Similarly, the family could no longer sell the assets of the business to a third party, via §337, or indirectly via §338, and apply their capital to other uses, except by incurring a 42.4% tax burden.* Nor could they liquidate the corporation and operate the business as a partnership or sole proprietorship, dividing the assets in kind among themselves as they see fit. Much of the healthy flexibility of our existing tax system as it applies to family businesses would be lost. I see no justification for removing this flexibility, which has been an important inducement to the formation of new, privately-held companies with fresh ideas and inventiveness.

The problem could be compounded by the fact that the family company may have been organized originally to incorporate business assets held in a sole proprietorship or partnership. The assets may have appreciated substantially in value, from inflation or otherwise, and specific intangible asset values may have arisen, before any such incorporation. The proposal would tax the pre-incorporation gain on these assets even though it did not arise in corporate solution. The result would be that the family would clearly pay a much greater tax than would have been payable if no corporation had been formed. There can be no tax policy justification for this result.

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* Technically, in a §338 transaction, the selling shareholders would not directly incur all of the 42.4% tax, but they would bear the burden of it partly through a reduced selling price in a cost basis acquisition.

Staff Report: Questionable Assumptions
As To General Utilities Rule

The Staff report commendably recognizes that there are substantial questions whether the General Utilities rule should be repealed:

> In addition to the preceding recommendations, the Staff has identified a number of options that ought to be considered if the Committee concludes that the outright repeal of the General Utilities rule is too harsh. (p. 5). (See also pp. 65, 93-94).

The American Law Institute, the recommendations of which were a major source of reference for the Staff's report, recognized the severity of a double tax on the long-term appreciation in value of business assets in a complete liquidation. The Institute recommended that the shareholder be allowed a credit for his share of the corporate capital gains tax against his individual capital gains tax to eliminate the double taxation. The credit is extremely complex. It also accomplishes little, to the extent the corporate and individual capital gain tax rates are essentially the same (as they should be with respect to the kind of gain in question here). The Staff rejects the ALI credit proposal on grounds of complexity and taxpayer compliance.

The Staff report gives nine arguments favoring repeal of General Utilities and three arguments against it. Before reaching them, it is critical to focus upon the basic assumptions of the Report in recommending repeal of General Utilities. These assumptions are that: (1) we have an unintegrated corporate tax system, it should be continued, and it should be rigorously applied (pp. 4, 55); (2) the primary consideration should be that the rules should be "simplest and least susceptible to abuse and manipulation" (page 4); and (3) tax abuse abounds, despite many Code provisions specifically developed to prevent it, because of the General Utilities rule (pp. 32-38). I respectfully submit that none of these assumptions is valid.

In fact, we have never had a truly unintegrated corporate tax system in which a tax is paid on income at the corporate level and a second tax is paid on corporate income by the shareholders. Over the seventy or more years that our corporate income tax system has developed, we have had a compromise system in which double tax has been imposed on ordinary earnings from regular operations to the extent they are distributed to shareholders as dividends, but only a single tax has been imposed upon extraordinary events, such as a sale or distribution of assets pursuant to a complete liquidation.

In reality, we have to a large extent had only a single ordinary income tax on regular corporate earnings because of the ability to retain earnings. By reason of our provision for step-up in basis of assets at death, earnings taxed at ordinary rates at the corporate level have to a large extent been retained and have not been taxed again at the shareholder level. At most, they have been subjected to a capital gains tax on sale of stock at the shareholder level. A large percentage of corporations in the U.S., both publicly-held and privately-held, retain and reinvest in their business a large percentage of their annual earnings, partly as a result of the tax advantages to their shareholders that flow from this policy.

This is an entirely healthy system. The corporate tax rate and top individual rate are roughly the same. There should be limits on the tax burden on income from capital so that capital formation is not inhibited or misdirected away from business investment. Further, to the extent we provide incentives through tax allowances, such as the investment credit, ACRS, the research and development credit, or the intangible drilling cost deduction, there should be no preference for operating in or out of the corporate structure.

Virtually all major foreign industrialized countries, including the entire European Economic Community and Canada, have moved toward a single integrated tax structure in which only a single income tax is paid on business earnings.

Economists tend strongly to favor such a system to avoid undue burdens on capital investment. We have obviously greatly moderated our tax burden on capital by the types of tax incentives previously described. As a practical matter, the effect of our present corporate tax structure is that by a variety of means we have achieved what is a single tax on the returns from capital, and this allows us to remain competitive in the world economy.

There is no important reason at this time to disturb this carefully-developed balance that has resulted from seventy or more years of experience in refining our corporate tax system to accommodate the needs of our economy and our society. It is particularly unwise to do so in a way that would impact harshly on privately-held, smaller companies. The primary consideration affecting our corporate tax structure should be economic efficiency, not simplicity or over-reactive concern with abuse and manipulation.*

The preoccupation in this Report with abuse and manipulation is disturbing. Admittedly, the extensive provisions we have developed to prevent abuse of the General Utilities rule, such as the recapture rules, the collapsible corporation provisions, new section 338, the recent repeal of the partial liquidation provisions the ACRS anti-churning rules, and others, are complex. Complexity, however, in a corporate tax context is manageable, and we have in fact learned to live with it. Further, despite the impressions suggested by the report, these anti-abuse provisions are effective in practice. In my thirty-plus years as a corporate tax lawyer, I have not seen any widespread circumvention of the collapsible corporation rules or these other provisions. When some special forms of abuse have developed, as they did in recent years, the Congressional response was swift and effective, as in TEFRA. We have developed a new legislative capacity to deal with these problems as they arise.

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* Integration of the corporate and individual tax has also been accomplished in other ways in our tax system. The obvious example is Subchapter S, but administrative considerations have forced the imposition of severe limitations on its use. Royalty trusts exist to receive and distribute certain forms of passive income. As recognized in the Staff report, publicly-traded limited partnerships now exist to operate going businesses. The report would treat publicly-traded limited partnerships as corporations. Widely-held limited partnerships, the interests in which are not publicly-traded, also exist, however, and the report would not reach these arrangements.

We must not make a fundamental change in our corporate tax structure to meet these relatively narrow concerns if it could substantially affect efficient allocation of capital resources in the United States. The effect of such a change has not yet been studied sufficiently in the context of repeal of the *General Utilities* rule in corporate complete liquidations. In addition, the possible effects of discouraging the use of corporations to operate privately-held businesses, in favor of partnerships the interests in which are not publicly-traded, royalty trusts, or other arrangements have not been fully evaluated. There are critical economic, legal, and social issues to be considered.

Accordingly, I urge this Committee to defer action on this critical matter at least until these kinds of evaluations have been done. Much more analysis is required to make the judgments that are required in changing the tax structure to increase burdens on privately-held companies.

Staff Report: Reasons For and
Against Repeal of General Utilities

The report (page 88) argues for taxing gain on corporate assets at the corporate level in complete liquidations first on the ground that taxpayers pay less tax because of the General Utilities rule than would be paid in the absence of a corporate tax. This is difficult to understand, since the main thrust of repealing the General Utilities rule is to impose a double tax on the appreciation in value of corporate assets, thereby raising the effective rate on such gain from 20% under existing law to 42.4%. No explanation of this argument in the report is given. Contrary to the impression given in the report, taxpayers will generally pay more tax if General Utilities is repealed than they would have paid in the absence of a corporate tax.

An earlier reference (p. 36) deals with a non pro rata liquidation in which the corporation has no earnings and profits and liquidates under §333, taking as a basis in the assets the shareholder's basis in his stock.* It is implied that an undue tax advantage arises in these circumstances, although it is not entirely clear what the undue advantage consists of. In any event, however, this is a highly unusual situation -- perhaps one in a thousand -- and is hardly justification for such a massive change in the tax system as the repeal of the General Utilities rule.

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* The example given may overlook the fact that depreciation is recaptured in a §333 liquidation, creating earnings and profits, and thus ordinary income consequences on the liquidation.

In the complete liquidation context, involving privately-held companies, it is useful to recognize that the shareholder's gain on liquidation consists of two elements -- retained earnings and appreciation in value of the company's underlying assets. There is no other source of shareholder gain. The shareholder may have bought his shares at a time when such elements existed to some degree; if so, his predecessor will have paid tax at the shareholder level on such elements. Retained earnings and appreciation in value of corporate assets ultimately always incur a tax at the shareholder level, except to the extent that stepped-up basis at death occurs or the shareholder is tax-exempt.

Further, the recapture rules insure that the ordinary income portion of asset appreciation ultimately is taxed, and as ordinary income. Retained earnings by definition have been taxed at the corporate level. What remains then is the capital gain portion of appreciation in value of corporate assets, which, as stated above, is ultimately taxed at the shareholder level, except where there has been an intervening death of the shareholder. Repeal of General Utilities in complete liquidations would tax this latter portion twice, once at the corporate level, and again immediately at the shareholder level except where there has been an intervening death of the shareholder.[*] If the business had operated in non-corporate form, this double tax would not have been incurred.

The anti-churning rules effectively prevent undue benefit from ACRS. The collapsible corporation rules, despite their complexity, prevent undue benefit from complete liquidations. There is no substantial opportunity to gain greater benefits by operating in corporate form than in non-corporate form.

The other reasons given in the report for this double taxation may be grouped. The second reason relates to complexity and abuse, a matter already discussed (supra p. 9-11). Repeal of the collapsible corporation rules is not necessarily a useful end in and of itself, regardless of what must be done to make it possible. There are important economic and social consequences to be resolved here; the world has lived with the collapsible corporation anti-tax avoidance rules for more than thirty years and can continue to do so. It is said that repeal will block certain tax-motivated acquisitions, but no specifications are given. TEFRA addressed such problems, and if further problems arise, they can be addressed equally promptly and equally specifically. It is said that repeal of General Utilities will limit churning under ACRS, but we already have in place an effective set of rules for that purpose. Finally, I submit that the seriousness of the liquidation-reincorporation problem is overstated; in my extensive corporate tax practice, I have seen very few instances of successful liquidation-reincorporations that produce substantial tax benefits. It is a wonderful conversation piece and tax teaching tool; it is not much of a real problem. In point of fact, the report can be read to endorse a form of liquidation-reincorporation not presently available. It would tax the corporation at capital gain rates, permit a step-up in basis of the assets (even though continuity of interest clearly exists), and permit depreciation deductions by reference to stepped-up basis to offset subsequent ordinary income from ongoing business operations.

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[*] As to the impact of stepped-up basis at death, see infra, p. 20.

Otherwise, the reasons for double taxation seem to boil down to a preference for greater purity in an unintegrated tax system --

> iv. General recognition of gain provides uniformity. ***
>
> v. Recognition broadens the corporate tax base. ***
>
> vii. The General Utilities doctrine allows tax on corporate gain to be avoided entirely. ***

All of these propositions assume there should be a double tax on appreciation in value of corporate assets at the time of a complete liquidation. As previously stated, there is no basis for this assumption (supra, p. 9-11), and it would have enormous adverse effects on privately-held companies in the U.S. (supra, p. 4-8).

The example given on page 89 of the Staff report is somewhat disingenuous. It deals with a dividend in kind of securities, not a complete liquidation. Presumably the corporation has earnings and profits, so the shareholders incur an ordinary income tax of $100,000 on the distribution of the securities. In a privately-held company, where this situation might most likely be presented, it would be an unusual transaction. If the securities represent stock, the parties would lose the advantage of the 85% intercorporate dividends deduction by placing the stock in the hands of the shareholders. Ordinarily it would be more advantageous, if the medium of investment were to be changed, for the corporation to sell the stock, incur the capital gains tax, and reinvest in other stock.

In any event, the real issue here is the treatment of a complete liquidation. As stated earlier, there is far less question about repealing the General Utilities rule with respect to ordinary distributions in kind. If, however, the stock is distributed in complete liquidation, should a tax of 42.4% be paid on the investment gain of $80,000, rather than a tax of 20% if the stock had been held outside the corporation? What rationale supports this result?

We have a generally efficient, fair, and workable system that presently stimulates capital formation by avoiding interference with allocation of capital to its most efficient uses in the economy. Initiative and productivity are stimulated by the ability to build up capital returns in a privately-held company. For the most part, all income and gain is taxed at least once, except to the extent we provide tax incentives for good reasons, whether economic (for example, business investment or R&D activity) or social (tax-exempt charitable or similar institutions). When abuses develop, they may be quickly corrected, particularly with the recent Congressional ability to move more promptly. We should not disturb the efficient functioning of the present system unless there are reasons of overriding importance. These have not yet been demonstrated.

The reasons given in the Report as against repeal of General Utilities are understated. It is not a theoretical argument as to "realization". It is a practical consideration. The repeal as applied in the complete liquidation context would greatly damage privately-held business in the United States.

To answer the question posed in the Report, a corporate liquidation is an event which warrants a single capital gains tax because it represents a liquidation of an investment, just as any other investment. The gain realized is likely to be largely inflationary rather than real. To the extent the gain reflects retained earnings, it represents income already subject to tax at the corporate level. If it has not been fully taxed at the corporate level, it is because some economic or social policy has been regarded by Congress as sufficiently important to call for a tax incentive provision.

Such gain is quite different from the regular earnings of an ongoing business. The comparisons drawn in the report to a 73% tax rate on ordinary income overstate reality. I doubt that any significant amount of income earned through corporations in the U.S. ever bears an effective tax rate even close to 73%.

The argument that liquidation of a corporation is often a highly formal step without economic substance is not valid. Few complete liquidations involve distributions of assets to the shareholders in kind. Most involve sales of assets pursuant to §337 or sales of stock deemed to be sales of assets under §338. The liquidation-reincorporation problem, as previously stated, is given far more emphasis in the Report than it deserves. Further, it simply is not the fact that complete liquidations are often tax-driven transactions; they generally result from a business conclusion that someone else can operate the business more efficiently and that the shareholders can direct their capital to more effective uses in the economy.

The Report correctly notes the argument against repeal that 42.4% is too high a tax rate to impose on investment gain at the time of a complete liquidation. The answer, however, is not to tinker with this rate. Instead, we should simply avoid increasing the extent of double taxation. Extraordinary gains arising on complete liquidation of a corporation should be taxed once, at regular capital gains rates, just as is all other investment gain.

Proposals for Relief from Repeal of General Utilities

The several options for mitigating the effect of repeal of General Utilities are testimony themselves that the proposal itself is of doubtful merit. In any event, as previously stated (supra p. 8), the ALI shareholder credit would be complex, though if General Utilities is to be repealed for complete liquidation transactions, some such relief would be essential. Phase-in of a double tax burden does do more than postpone temporarily the adverse economic and social consequences of the change.

The exemption of gain from certain long-held assets could solve many of the inequities and problems presented and should be carefully considered if General Utilities is to be repealed. Similarly, in such event, some form of carryover or substituted basis solution has merit and should be carefully explored.

The reference to step-up in basis at death at page 93 of the report is curious; elsewhere in the report, it is stated that a fundamental premise of the study is that step-up in basis at death is to be continued (page 4). Viewed in a broader sense, particularly in connection with Subchapter S small business corporations, repeal of the General Utilities rule can be viewed as essentially an attack on stepped-up basis at death despite the assurance in the report to the contrary.

Surely a piecemeal repeal of step-up in basis at death, affecting only gains realized from investment in corporate business activity, is not good tax policy.

Conclusion

The Committee should not repeal General Utilities in the context of complete liquidations and impose a double tax burden on asset appreciation. An effective tax rate of 42.4% on such gain will have severe adverse effects on privately-held companies. It will create a bias causing owners of family businesses contemplating liquidation to merge their corporations into publicly-held companies in exchange for stock of such companies. Capital will not be directed to its most efficient uses in the United States economy.

The CHAIRMAN. I think I will just ask the other two members of the panel—you have heard what Mr. Nolan has said, that current tax law provides a healthy flexibility and urges that the repeal of the General Utilities would unduly burden American business. You are the experts, so I need to find out if you agree with that.

Mr. ALEXANDER. I think it is a case beautifully stated and beautifully overstated. I think the problem can be solved, to the extent there is a problem, by the shareholder credit that Professor Andrews was describing.

The CHAIRMAN. Mr. Jacobs?

Mr. JACOBS. I tend to agree, although my personal predilection would be to exonerate the tax as to long-held capital gain property on the death of a corporation, the liquidation of a corporation, or the sale in a cost-basis election mode.

But it seems to me, whether you use the credit or whether you use exoneration, or whether you even use the phasein as suggested in the report, any of those would, I believe, take care of John's problem of dealing with people's expectations in this connection. In all events it should be limited to long-held capital gain property.

Mr. NOLAN. Mr. Chairman, could I say that I wonder whether the complexity is worth it. If the capital gains tax on corporations is at a higher rate than the capital gains tax on individuals, and we give a credit to the shareholders with respect to the capital gains tax paid by the corporation, I wonder whether the complexity is really worth it.

The CHAIRMAN. Well, that's what we hope to determine between now and the time we pass something. You may already know, but I don't know yet. I don't have any clients, so that——

[Laughter.]

The CHAIRMAN. Your testimony notes that you agree with many of the major elements of the report. I wonder which ones they are.

Mr. NOLAN. I agree, in general, with the effort in the report to change the treatment of acquisitions so that the treatment of shareholders is divorced from the treatment at the corporate level.

I think that it is necessary in applying the corporate level tax system of cost-basis acquisitions versus carryover basis acquisitions to retain some of the elements that we previously have had in section 337 and section 338, with respect to sales of assets in connection with complete liquidations, and sales of stock in connection with what are effectively complete liquidations. I think those provisions can be improved.

So I think a great deal of the report is very valuable, and I subscribe to it. It's just that I think the issue of repeal of the General Utilities rule raises many problems that need a great deal more consideration, particularly with respect to privately-held companies.

The CHAIRMAN. I think that is an area we are going to have to spend some time on. In fact, nearly every aspect of it we are going to spend a great deal of time on.

Mr. Jacobs, do you have any recommendation on the timetable? You spent how much time on this project?

Mr. JACOBS. The narrow project of the ABA with which I worked so hard probably rivaled the work of the ALI in terms of length, if not what we produced. It lasted some 8 or 10 years, to produce the narrow answer in 368.

But I think what we have here from the staff is the right answer. I think the people who have looked at this and worked on the narrow project agree. I would think that this Congress, the 98th Congress, is the Congress to pass this change.

The CHAIRMAN. It was also suggested by a prior witness, I guess by the Treasury witness, that we shouldn't lean too hard on simplification, but that isn't going to be the strongest reed to lean on.

Do you think we are going to simplify? That's one of the purposes—that and some other areas.

Mr. JACOBS. I guess that simplification depends upon the beholder. From my perspective as a practitioner, simplification comes when there is certainty; when you know what the rules are and everybody is playing by the same rules, you are going to get simplicity, and you are going to get fairness.

In the net operating loss area, for example, we have a situation where today if a company has a net operating loss it can sell it for 10 cents on the dollar. The purchaser is getting the present value of 46 cents on that net operating loss that it buys, and the Treasury is paying 36 cents, even assuming we approve transfers.

I would think, in the net operating loss area, for example, you ought to know exactly what the net operating losses were, so that the buyers and sellers can do their own trading and the Treasury Department can quit subsidizing these acquisitions.

The CHAIRMAN. As I have indicated earlier, this is not a hearing on specific legislation. We hope to have some ready to introduce later this year or early next year.

We do intend to pursue the project. We may find some areas, as Mr. Nolan has pointed out, that need to spend more time on, modify, whatever—we are flexible.

We appreciate very much your testimony, and we will be working with you and members of your staffs.

Mr. NOLAN. Thank you, Mr. Chairman.

The CHAIRMAN. Our next panel consists of Edwin S. Cohen of Covington & Burling in Washington, D.C., on behalf of the Chamber of Commerce of the United States; and Thomas P. Maletta, vice president, Taxes, Allegheny International Inc., Pittsburgh, Pa., on behalf of Tax Executives Institute, Inc., Arlington, Va.

They will be followed by a panel, I might just announce so they can move up to the front, consisting of Leon M. Nad, national director, Technical Tax Service, Price Waterhouse, Washington, D.C.; David A. Berenson, Ernst & Whinney, Washington, D.C.; Nicholas Tomasulo, Silverstein & Mullens, Washington, D.C.; Richard L. Bacon, Bell, Boyd & Lloyd, Washington, D.C.; and James Rocne, McDermott, Will & Emery, Chicago, Ill.

Eddie.

STATEMENT OF EDWIN S. COHEN, ESQ., COVINGTON & BURLING, WASHINGTON, D.C., ON BEHALF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES, WASHINGTON, D.C.

Mr. COHEN. Mr. Chairman, I am Edwin S. Cohen. I appear today on behalf of the Chamber of Commerce of the United States of which I am a Director and Chairman of its Tax Committee.

The preliminary report of the committee staff represents a major contribution in a highly complex field of the law and contains many hopeful recommendations.

Our written statement discusses three proposals in the report that cause us special concern. In the interest of time I will comment on only one of these, the proposal that Mr. Nolan commented on that would impose a double capital gains tax on the sale or liquidation of an incorporated business containing assets that have appreciated in value.

If I may, I'll use a simple example to show our concern:

Suppose individual A opens a drugstore and buys for $10,000 land and building in which the store operates. Thirty or 40 years later he retires and sells the building, including the land and building that have now over this long period of time appreciated to $110,000.

If he has operated the business as a proprietorship without incorporation, he has a long-term capital gain of $100,000, and he pays a maximum tax of $20,000. Under the existing law he will pay the same tax if he had incorporated the business. On his retirement, he would sell the stock, or have the corporation sell the asset and distribute the proceeds, and his tax would also be at 20 percent, or $20,000.

Under the proposal, however, A's corporation would have to pay a corporate capital gains tax of 28 percent, or $28,000. When the corporation dissolves and distributes its assets to him, he will pay, in addition, 20 percent on the $72,000 of gain remaining, or $14,400. So his total tax burden will be $42,400 whereas if he hadn't incorporated he would have paid a tax of $20,000. As Mr. Nolan said, it increases his rate of tax from 20 percent to 42.4 percent.

The same double tax problem would exist for a farmer if, for any number of reasons, he has incorporated his farm and it has appreciated in value.

In our written statement we discuss various suggestions that achieve some alleviation of this result that we think would be unfair.

The CHAIRMAN. Could he elect subchapter S in that case?

Mr. COHEN. Well, he could if he met all of the circumstances that permit him to elect subchapter S.

The CHAIRMAN. Because last year, as you recall, we did liberalize that.

Mr. COHEN. Yes; we go into that in our statement. If you change subchapter S to eliminate some of the conditions, it might take care of it for the closely held companies; but, for example, if he incorporated because he had children and wanted to leave some of the stock in trust for his children, he couldn't use subchapter S. If, for various reasons, such as in the case of a high technology company, the corporation has a second class of stock, he can't use subchapter S.

We do not think that those limitations are necessary, and perhaps one solution would be to expand subchapter S.

However, without going into the ramifications of subchapter S, and appreciating some of the points that the Treasury made earlier today that require further study, there are other possible solutions to this problem. But until the solution appears on the scene, I would join Mr. Nolan in his comments, and I think the chamber would also.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

[The prepared statement of Edwin S. Cohen follows:]

STATEMENT
on
SENATE FINANCE COMMITTEE STAFF PROPOSALS
for
REFORM OF CORPORATE TAXATION
before the
SENATE COMMITTEE ON FINANCE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Edwin S. Cohen
October 24, 1983

My name is Edwin S. Cohen. I am a member of the Board of Directors and Chairman of the Taxation Committee of the Chamber of Commerce of the United States, on whose behalf I appear today. I am a member of the law firm of Covington & Burling, of Washington, D.C. Accompanying me are David E. Franasiak, Manager of the Tax Policy Center of the Chamber, and Rachelle B. Bernstein, its Senior Tax Counsel.

The preliminary report of the Committee Staff for revision of the corporate tax structure represents a prodigious effort in a highly complex field and contains many helpful analyses and recommendations. We commend the Staff for the thoroughness of its work.

Because of the difficulty and breadth of the subject, the report requires careful and extensive study in order to comprehend and appraise the practical efforts of the proposals on various types of business transactions. In view of the diversity of businesses represented in the Chamber's membership, we have been engaged in analyzing major aspects of the proposals as they may affect both small and large incorporated businesses, both those that are closely held and those that are publicly traded. Some of our preliminary conclusions are set out below. We look forward to the opportunity of offering further comments and assistance to the Committee and its staff as the work continues.

1. The Proposals Leading to Double Taxation of Gains on Sales or Liquidations of Corporations.

The Chamber's preliminary study of that part of the report that proposes new rules relating to sale or liquidation of incorporated businesses leads us to voice most serious reservations as to their effect, especially on small closely held corporations. We are concerned in particular that the proposals would discourage the use of corporations as a means of conducting business. This would occur, we believe, because on the eventual winding up of the incorporated business by sale or liquidation, either a double tax would be incurred on appreciated capital assets or a purchaser would pay less than fair market value for those assets. We are particularly concerned about the effect on those businesses that are already incorporated and cannot now change to an unincorporated form of business without incurring substantial tax.

The double tax could be avoided by foregoing in the future the formation of a corporation, but there are often legal and practical infirmities in conducting a business in partnership or proprietorship form. Indeed, for this reason the long established policy of the tax law has been to facilitate the use of corporations to conduct business, and especially so for small business. While we appreciate the concerns that have led the Staff to try to solve other problems in the corporate tax area by proposing the double tax, it is our tentative conclusion that this proposal would be far too drastic a remedy and should not be adopted. Other solutions with less serious consequences are available.

A simple example will explain the Chamber's concern. Individual A opens a drugstore and buys for $10,000 the land and building in which the store operates. Thirty years later he retires and sells the business, including the land and building now worth $110,000. If A has operated the business as a proprietorship, without incorporation, he has a long-term capital gain of $100,000 on the sale of the land and building, on which he pays a maximum tax of $20,000.

Under existing law he would pay the same tax if he had operated his business as a corporation. On his retirement he would sell the stock of the corporation, or have the corporation sell the land and building and distribute the sales proceeds to him on liquidation and winding up of the corporation. Either way his tax would be $20,000, just as if he had not incorporated.

Under the proposals, however, A's corporation would have to pay a corporate capital gains tax of 28 percent, or $28,000; and when the corporation would be dissolved he also would pay a capital gains tax (on the remaining $72,000) that could amount to 20 percent, or $14,400. His total tax burden on the sale would be $42,400 -- more than twice the tax he would have paid if he had not incorporated his business.

We do not believe that result would be fair. It would not be sound tax or economic policy to impose such a double tax burden on a business wholly owned by one small businessman merely because for any number of reasons he operated his business as a corporation rather than a proprietorship.

As some amelioration of this result, the proposals would provide that the corporation would not have to pay the 28 percent corporate capital gains tax if the corporation sold the land and building to an incorporated purchaser and the two corporations agreed that the purchasing corporation would take over the $10,000 tax basis of the property in the hands of A's corporation. But that rule would reduce the price that A could obtain for the property for two reasons: first, the purchasing corporation would not pay the full value of $110,000 for the property because of the adverse tax consequences it would have by reason of having only a $10,000 tax basis for it; and second, to relieve his corporation of the 28 percent tax on the sale, A would have to forego selling to individual investors and could only sell to corporations, thus significantly limiting the pool of potential buyers.

The same double tax or loss of value would occur under the proposals if A had originally started his business in unincorporated form but had later incorporated it. Under existing law (Code Section 351) A's low tax basis for the property would carry over to his corporation, and he would have the same low tax basis for his stock in the corporation. This would produce the same double tax or loss in value under the proposal when he retires and sells out.

The same double tax problem would exist for a farmer who for any number of reasons may have incorporated his farm, if the farm has appreciated in value.

Subchapter S Corporations. The Staff report proposes that the 28 percent corporate tax on the sale of property would not be applicable if the corporation and its shareholders have elected to be taxed under Subchapter S. Under the provisions of Subchapter S a corporation is relieved of tax on its income, which is taxed currently to the shareholders in their individual tax returns. Subchapter S would be available to provide relief from the double tax if there are less than 35 shareholders of the corporation, but only if the corporation satisfies certain other requirements. Among those other requirements are (1) with limited exceptions all the shareholders must be individuals; and (2) the corporation may have only one class of stock.

Often a business or a farm is incorporated because of a desire to leave stock in trust for a surviving spouse or children in the event of the owner's death. In other cases, more than one class of stock is needed to provide for the varying needs of a surviving spouse or different children, or employees or other investors. Especially in new and innovative industries, such as those involving high technology, a special class of stock may be required to raise venture capital. Either the existence of a trust shareholder or of more than one class of stock will disqualify the company under Subchapter S and under the proposals lead to the double tax when the business is sold and wound up.

These two grounds for disqualifications have long existed in Subchapter S because of the administrative problems involved in taxing income of the Subchapter S corporation to its shareholders even though it is not actually distributed. In the case of trust shareholders or multiple classes of stock, there would be serious administrative difficulties in determining the persons to whom the undistributed income should be taxed, because it is not clear who will ultimately receive the income when it is actually distributed. But that administrative problem does not exist when the incorporated business is being sold and completely liquidated, because at that point in time there is necessarily an actual distribution to shareholders and the person who receives it is known.

Accordingly, in weighing the Subchapter C proposals it would seem desirable to reconsider the dividing line between Subchapter S and Subchapter C corporations when the incorporated business is sold or completely liquidated, because the proposals would involve major tax differences depending upon the category in which the corporation fell.

Death of a Shareholder. The provisions for carryover of basis at death, adopted in 1976, were repealed by the Congress in 1980, with the result that upon the sale of his capital assets after his death no capital gains tax is payable by the decedent's estate or his heirs on appreciation occurring before his death. This is true whether the assets were held by the decedent in an incorporated or unincorporated business. Under the Staff proposal this would continue to be true if the business were unincorporated, but it would no longer be true if it were incorporated. If the business were incorporated, the corporation would have to pay a capital gains tax up to 28 percent, even though the value of the business was subject to estate tax (unless the corporation was a Subchapter S corporation or the property were sold to another corporation which would agree to take the property at its low tax basis). It is difficult to justify the imposition of a 28 percent capital gains tax, in addition to the estate tax, simply because the decedent operated his business in corporate form.

The carryover basis proposal, adopted in 1976 and repealed in 1980, would eventually have caused a capital gains tax to have been paid by the decedent's estate or his heirs, whether or not the business was incorporated. But at least the 1976 carryover basis rule was intended to apply only to appreciation occurring after 1976, and it had provisions to ameliorate the double burden of the estate tax and the capital gains tax. The present proposal, however, would impose the corporate capital gains tax on appreciation that has heretofore occurred, and without relief by reason of the imposition of the estate tax. Indeed, unless the property is actually sold promptly after the decedent's death, it is not clear that the burden of the corporate capital gains tax would be taken into account in valuing the shares for purposes of the decedent's estate tax. Thus the proposal has serious ramifications for the owners of incorporated businesses, as against owners of unincorporated businesses, in planning their estates for the benefit of a surviving spouse or children.

Practical Effects. The proposal to impose a double tax on appreciated property held by corporations would undoubtedly have major practical effects. Among these would seem to be the following:

(1) The inability to wind up the business without a double tax would tend to inhibit the formation of corporations, and in particular the incorporation of businesses already existing in proprietorship or partnership form. Rather than simplifying the corporate tax area, this aspect of the proposals would require the small entrepreneur to seek sophisticated tax advice.

(2) One type of sophisticated tax advice would be that on the incorporation of a business land and other capital assets should not be transferred into corporation ownership, but should be retained in individual ownership and leased to the incorporated business. Individual ownership would prevent an ultimate double tax. But this would be a cumbersome and more expensive procedure, would impair the financial capacity of the company, and it would raise questions on I.R.S. audits as to the propriety of the rent charged by the inidividuals to their controlled corporations.

(3) Once appreciated land or other capital assets are in fact owned by the corporation, they would be likely to be sold only to other corporations that would agree to take over the low tax basis. Thus, once owned by corporations, those assets would be likely to stay in corporate ownership, limiting the pool of possible purchasers and producing marketplace effects that are extremely difficult to foresee.

Subsidiaries. The report indicates that a corporate purchaser of assets of another corporation would have to elect carryover basis for all the assets acquired from a particular corporation or elect cost basis for all those assets; but if in the same transaction it were to acquire the assets of a parent corporation and those of a subsidiary, it could elect cost basis for the assets of one corporation and carryover basis for those of the other corporation.

We are concerned that this rule might create serious uncertainty as to whether particular assets should be held by a wholly-owned subsidiary, rather than by its parent corporation, in order to make the choice of carryover or cost basis available to a prospective purchaser in the event the business is sold. Corporate structures would be influenced by this prospective tax advantage rather than being dictated by business needs and convenience. The policy of the tax law for some time has been to equate the tax burden on corporations operating through divisions with those operating through subsidiaries, a policy which we believe is proper and which would be contravened by this proposal.

We are uncertain as to the intention of the proposals with respect to the treatment of a selling subsidiary and its parent corporation when carryover basis would be elected by the purchasing corporation for assets acquired from the subsidiary. We believe clarification is required to make certain that it is not intended to impose multiple layers of corporate tax as well as a shareholder tax on the sale of a business.

These problems with respect to subsidiaries would require careful thought. If there are different tax results on sales of property depending upon whether assets are held in subsidiaries or by a parent corporation, not only would mere differences in corporate structure produce widely different tax results, but in addition we would revive the problems of step transactions that led the ~~Congress~~ in adopting the Internal Revenue Code of 1954 to install the present rules. If taxes could be saved by having property owned in a subsidiary, attempts would be made to transfer property to subsidiaries shortly before a sale, leading to I.R.S. challenges as to the efficacy of a last minute transfer. Similarly, liquidations of subsidiaries shortly before a sale would lead to unsettled results. These difficult issues, largely set at rest in 1954, should not now be revived.

Relief from Double Tax. The press release of the Chairman asks for comments as to the appropriate form of temporary or permanent relief from tax to the corporation on the distribution of appreciated property. We assume that this includes similar relief where the corporation sells its assets as a part of a plan of complete liquidation.

The principal difficulty in answering this question stems from the proposal to impose a corporate tax as well as an individual tax at the time the corporation's business is sold or liquidated. As stated earlier, we do not believe it would be wise to change the policy of a single tax at the time of sale or liquidation of the business, a policy that was adopted by the Congress in 1954 after much study.

We are not inclined to believe that the 10-year transitional rule mentioned in the Staff report (pp. 65-66) would provide an acceptable solution. In the first place, the proposal would mean that in less than 6 months there would be imposed a 4 percent corporate tax, and in less than 15 months an 8 percent corporate tax, rising gradually thereafter to 28 percent by 1995. Those willing to sell or liquidate before April 1, 1984 could do so with only the present single tax. However, many properties and businesses cannot be sold in that short a time frame, and many business people would be reluctant to sell their businesses so quickly in order to avoid a new tax. Dissolving the corporations now and postponing a sale to third parties until a later date would eliminate the double tax, but would generally necessitate the payment of a substantial capital gains tax by the shareholder on the liquidation of the corporation -- a tax which he may not have the funds to pay until he sells out.

Beyond that, there are often serious nontax problems associated with the dissolution of a corporation prior to the sale of its assets, because of the possibility of minors or trustees becoming direct participants in the business, personal liability to creditors of the business, etc. Thus we are concerned that the owners of closely held corporations would be under severe pressure to take steps which would be unwise except for the purpose of eliminating the proposed new tax.

The recent American Law Institute study suggested that the added burden of the double tax be ameliorated by allowing a credit against the stockholder's tax for the corporate capital gains tax paid at the time of the sale and liquidation of the business. Despite some problems with that approach, it would represent, in our judgment, a distinct improvement over the current proposals. However, it has certain difficulties, among which are:

(1) The corporate capital gains tax at present is 28 percent, whereas the maximum individual capital gains tax is 20 percent. It would seem appropriate, at least in the case of the sale of a closely held business, to apply the individual rate;

(2) A decedent's estate or his heirs would still bear the burden of the corporate capital gains tax although they would have had no tax if the business had been unincorporated; and

(3) There is necessarily some complexity in the calculation of the credit.

If the double tax were to be enacted, there is a strong case to be made for exempting appreciation that has occurred to date on property held in corporate ownership, along the lines of what was done when the income tax was enacted in 1913 or when carryover basis at death was adopted in 1976. Any such rule would have administrative difficulties, however, and there would still remain a discouraging effect on the use of corporations to carry on business because of the double tax on future appreciation.

In summary, we have not found, as yet at least, an acceptable form of relief from the proposal to impose the double tax. We believe that other answers — with far less adverse consequences to business generally — can be found for special problems (such as the collapsible corporations, liquidations-reincorporation, etc.) for which the double tax proposal has been designed. We do not believe that the benefits to be derived from the broad scale change from a single tax to the double tax on the sale of an incorporated business are sufficient to warrant the serious problems and difficulties it would engender.

2. The Proposed Elimination of the Earnings and Profits Test for Dividend Taxation

The report recommends that, with a limited exception, distributions by corporations to shareholders would be treated as taxable dividends, whether or not the corporation has operated profitably. For many years such distributions have been regarded as a return of capital if the corporation has no earnings or profits. It is true that there have been a number of difficulties in determining the meaning of earnings and profits, and it may well be desirable to deal specifically in the statute with some of those issues. We would be concerned, however, with the complete repeal of the earnings and profits concept and a substitution of a rule that all corporate distributions are fully taxable.

The report acknowledges that for certain purposes it would be necessary to retain the earnings and profits concept, thus leaving the definition of earnings and profits still to be considered. Moreover, there are cases where the earnings and profits ceiling on the amount of the taxable distribution prevents an unfortunate tax disaster. For example, it is not always clear whether a stock dividend or a recapitalization involves a nontaxable or a taxable distribution, and the earnings and profits ceiling puts a cap on the amount of tax involved; the absence of a cap could cause a taxable stock dividend to involve tax liability on an amount equal to substantially the entire value of the company. Again, the rules of section 306, relating to the disposition of stock dividends, and those of section 355, relating to corporate divisions, have long been geared to the existence of earnings and profits, and it is not clear what tests would be substituted. Moreover, there are issues of so-called "constructive" distributions to shareholders which could lead to excessive taxes in the absence of an earnings and profits ceiling.

Especially in the case of closely held corporations, it is simply unfair to impose taxes on individual shareholders when their corporation has not operated profitably. Difficult as is the earnings and profits problem, we do not believe it fair or appropriate to abolish it in its entirety.

3. The Dividends Received Deduction

The Staff proposes that the present 85 percent dividends received deduction be amended so that it would be available on dividends received by a corporate shareholder only if the stock is held for more than a year. It has also proposed to amend section 265 to disallow 85 percent of the interest paid on debt incurred to purchase or carry stock producing dividends eligible for the dividends received deduction. The report indicates that "an objective rule" would be provided, but does not specify the nature of the rule.

There seem to be three distinct aspects of this proposal:

(1) Whether the dividends received deduction should be restricted if the stock is sold within one year, even though no interest has been paid by the taxpayer and no loss incurred on a subsequent sale of the stock;

(2) Whether some limitations should be imposed on the taking of a short-term capital loss upon the sale of the stock within one year if dividends have been received subject to the 85 percent deduction; and

(3) Whether some limitations should be placed upon the deduction for interest paid by a corporate stockholder while receiving dividends subject to the 85 percent deduction.

These three issues should not necessarily be resolved in the same manner.

Income from operations of a corporation is not only subject to corporate income tax but when distributed to individual shareholders as a dividend is again taxed to the shareholders. Thus there are normally two layers of tax on ordinary dividend income. If a corporate shareholder were not granted relief on dividends received there would be two or more layers of corporate tax, as well as a layer of individual tax when the recipient corporation makes distribution to its own shareholders. The 85 percent deduction for intercorporate dividends provides that relief for the recipient corporation; without it the cumulative burden of corporate taxes would clearly be excessive. Accordingly, we believe the dividends received deduction should be retained in the absence of abusive situations, and any new restrictions should be designed solely to combat perceived abuses.

We believe it would be unwise to restrict the deduction to cases in which stock has been held by a corporation for less than a year. Such a rule would represent a generalized restriction, not limited to any perceived abusive situation. It would leave every corporate investor uncertain as to its tax position, since any number of supervening events could make it necessary to dispose of the stock within a year. The one year dividing line between long-term and short-term capital gains and losses is related to entirely different considerations and has no bearing on the policy issues involved in preventing multiple layers of corporate taxation on dividend income.

Any issue regarding limitations on short-term capital losses realized after the receipt of large dividends can be dealt with by revising rules restricting further the use of short-term capital loss deductions. To restrict loss deductions it is not necessary to alter the dividends received deduction. As in section 246 of existing law, distinctions between preferred stocks and common stocks would seem appropriate if loss deductions are to be restricted further.

The proposed limitations on deduction by a corporation of interest incurred while it receives dividends on stock in other corporations would present a number of difficult problems. The report suggests some type of amendment to section 265, which now limits deductions for interest on indebtedness incurred to purchase or carry tax-exempt state and local obligations, but the form of the amendment is not specified.

The section 265 rule, with respect to tax-exempt obligations, has been difficult to administer on a fair and equitable basis, and has been the subject of much litigation. An effort to extend that rule to ownership of stock in other corporations would be fraught with difficult policy and administrative issues. For example, unlike tax-exempt state and local obligations, stocks do not necessarily pay regular dividends and some may pay no dividends at all or pay them infrequently; indeed, they are frequently held with the hope of producing taxable gains rather than dividend income.

In addition, care would be needed to avoid disturbing debt incurred by a corporation to purchase or build a plant, equipment or office building, or to finance receivables or inventories, at the same time that the corporation [illegible] stock of another corporation. There may be reasons to distinguish between portfolio investment and investment constituting a major interest in another corporation, or between investments in common stocks and in various types of preferred stocks. Many of these considerations caused the Congress in the Tax Reform Act of 1969 to provide in Code Section 279 only a narrow limitation on the deduction of interest incurred by a large corporation acquiring stock or assets of another corporation.

Accordingly, we urge the Committee to refrain from adopting a generalized restriction on the dividends received deduction and to be quite cautious about any limitation on corporate interest deductions. We believe any changes should be confined to dealing with limited areas involving perceived abuses.

Due to limitations of time we have confined our statement today to certain major issues about which we are particularly concerned. The Report contains many helpful recommendations on which we have not commented specifically in this statement. It represents a major contribution in a complex area of the tax law. We trust we can have the privilege of being of assistance to the Committee and the Staff in its further consideration of this important subject.

STATEMENT OF THOMAS P. MALETTA, VICE PRESIDENT, TAXES, ALLEGHENY INTERNATIONAL CORP., PITTSBURGH, PA., ON BEHALF OF TAX EXECUTIVES INSTITUTE, INC., ARLINGTON, VA.

Mr. **Maletta**. Mr. Chairman, I am Thomas P. Maletta, vice president, Taxes, of Allegheny International Corp. and a former president of Tax Executives Institute of Arlington, Va. I appear today on behalf of TEI, an organization that represents 2,000 corporations in North America and all of the Fortune 500.

Our support for the goals of the staff study is tempered by our concern that the business community and the general public have not been afforded adequate time to review and reflect upon the staff's sweeping and in themselves complex proposals and I would personally suggest that a representative of the corporate community be included in further studies of this report by the various professional associations inasmuch as they are the group that is affected by the proposed legislation.

Based upon our preliminary analysis of the staff report, we offer the following comments:

First of all, on the proposal that imposes a double taxation on corporations as well as shareholders, I won't restate what Mr. Cohen of the U.S. Chamber has previously stated; but I would just like to comment on the fact that this proposed measure clearly impacts the viability of small businesses to be acquired by another corporation of equal or greater size. We feel that this is a substantial imposition of tax at a level of what has heretofore been tax free at the corporate level and is a detriment to conducting business in the corporate format for small businessman.

Second, with respect to the limitation of dividends received deductions, we find this troublesome in that it deals in an area that has historically served as a legitimate limitation to the multiple levels of taxation. TEI believes that the staff proposal represents an overboard, unduly harsh reaction to limited situations in which leveraged investments in preferred stock may have led to abuse.

Third, TEI believes that the staff's proposal to eliminate the earnings and profits limitation to the treatment of corporate distributions is totally unsupportable. This provision would undoubtedly lead to the taxation of capital. The staff's proposal seems to be largely based on the contention that earnings and profits are difficult for both the Internal Revenue Service and the taxpayers to compute. We believe, Senator, that the ease in administration seems hardly a reason for such a radical change in tax policy.

And, Senator, in fact the more complex area of foreign taxation as impacted by E&P is not addressed in this issue.

Last, we are not prepared at this point to comment on all of the substantive changes in the proposed section 382, but we would like to point out an apparent cause for concern under the staff's proposed change on the purchase rule. Net operating loss carryovers would be computed by applying an assumed rate of return to the assets owned by a loss corporation at the time of ownership. TEI questions the validity of applying universal rates of return to corporations in various industries.

Mr. Chairman, we can understand that limitations on net operating losses might be an area of concern, but we also believe that what occasioned the net operating loss for the most part was duly paid for in an economic loss of cash and that there ought not to be a general overall limitation on net operating losses except in specific abusive situations.

[The prepared statement of Thomas P. Maletta follows:]

Statement

of

Thomas P. Maletta
Vice President - Taxes
Allegheny International Inc.
Pittsburgh, Pennsylvania

on behalf of

TAX EXECUTIVES INSTITUTE, INC.

on

Proposals for Reform and Simplification of Corporate and Shareholder Income Taxation

before the

Committee on Finance
United States Senate

October 24, 1983

Mr. Chairman and Members of the Committee: I am Vice President - Taxes of Allegheny International Inc. of Pittsburgh, Pennsylvania and a former president of Tax Executives Institute, Inc. of Arlington, Virginia. I appear today on behalf of TEI, a professional association of corporate and other business executives who are responsible for the tax affairs of their employers.

Perhaps more than the members of any other professional group, TEI members will be vitally affected by legislation changing the way corporations and their shareholders are taxed. TEI is the principal association of corporate tax executives in North America. Our 3800 members work for more than 1100 of the leading corporations in the United States and Canada. No single industry dominates TEI. We truly represent a cross-section of the business community and believe that our diversity and dedication to the tax function qualify us to address issues concerning the administration of the tax laws and the effective implementation of tax policy. Tax Executives Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws throughout the nation and to reducing the costs and burdens of administration and compliance to the benefit of government and taxpayers alike. We appreciate the opportunity to appear before the Committee today to express our preliminary views on the September 24 report of the Staff on reform and simplification of corporate and shareholder income taxation.

General Comments

Many of the provisions of subchapter C of the Internal Revenue Code are unnecessarily complex, and TEI commends the Committee on its efforts to identify the problem areas and to reform and simplify the provisions governing the income taxation of corporations and their shareholders. We generally endorse, for example, the Staff's proposals to simplify and streamline the definitions relating to reorganizations. Similarly, we believe the abolition of the judicially created requirements of continuity of interest and continuity of business enterprise is laudable. These changes alone would constitute significant reform.

TEI's general support of simplification of subchapter C, however, is tempered by our concern that tax professionals, the business community, and the general public have not been afforded adequate time to thoroughly review and reflect upon these sweeping and, in themselves, complex proposals. The Staff devoted 11 months to the preparation of its report which was issued barely a month ago, and although the American Law Institute and others worked with the Staff, we seriously doubt they and other interested parties have had sufficient time to digest the report and consider all the possible ramifications of the Staff's proposals. Certainly this is true for many of us who are directly involved in the day-to-day functioning of the business community. Surely, the need for reform is not so pressing that it outweighs the need for careful, thoughtful consideration in an area that has such a direct and significant effect on the manner in which business is conducted and investment is made.

It cannot be denied that the taxation of corporations and their shareholders is complex and that changes are both necessary and desirable. It should also not be denied, however, that the law will continue to be complex. Consider, for example, new section 338 of the Code, which was enacted as part of TEFRA.

Although the provision was prompted by a desire to simplify and reform the rules governing stock purchases treated as asset acquisitions, it is itself extraordinarily complex and, as a review of the pending technical correction bill demonstrates, hardly resolves or even anticipates all the questions it raises.

Stated simply, TEI believes that the goals of simplification and reform are neither incompatible with the orderly review of legislative proposals nor necessarily served by accelerating and truncating the hearings process. Enactment of any legislation without meticulous consideration of each specific proposal and its possible effects could well result in the development of rules that are not only as complex and cumbersome as the rules they replace but that also create new uncertainties and distort economic behavior to a far greater degree. Consequently, we urge the Committee to significantly extend the comment period on the Staff's report and to take steps to ensure that legislation is not enacted until all interested parties have had ample time to consider the full effects of the Staff's proposals.

Comments on Specific Staff Proposals

In addition to our general comments, TEI offers the following comments on certain specific Staff proposals that, on the basis of our preliminary analysis, we find troublesome.

Recognition of Gain at the Corporate Level on Distributions of Appreciated Property

In general, Tax Executives Institute opposes any proposal that imposes a double tax on certain transactions between corporations and their shareholders -- specifically, distributions of appreciated property in liquidation or as dividends. We believe that nonrecognition at the corporate level in liquidations serves valid economic purposes and that the Staff's proposals, if adopted, could cause undue hardship. Our concern can best be illustrated by the following example. Assume two individuals transfer property to a new corporation in exchange for its stock. Shortly thereafter (but after the property has appreciated), they decide to terminate the business and go their separate ways. They liquidate the corporation and take back the property they each had contributed when the corporation was formed. Under the Staff's proposals, the price for dissolving the business relationship would be a double tax, even though (as the Staff acknowledges) the economic interests of the two individuals have not changed.* This would occur even in situations where the property had appreciated prior to incorporation. There is no economic justification for this harsh result which would make the corporate form less attractive as a vehicle for conducting business and might significantly alter business decisions and investment patterns with unforeseen results.

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* Even in situations where a shareholder can make an election under section 333 of the Code (assuming that election would continue to be available), there would be a tax imposed at the corporate level where none is economically justifiable.

Furthermore, the Staff's proposal to repeal section 337 (sales pursuant to a plan of liquidation) which is incorporated by reference in new section 338 could have deleterious effects on owners of corporate businesses. A buyer wishing to acquire the assets of a business and desiring to take those assets at a cost basis by purchasing the stock of the corporation and making a section 338 election would, under the proposal, pay less for the stock because he would not only have to bear the burden of recapture taxes (as under current law) but would also be faced with a tax on gain at the corporate level. The economic impact of the additional tax would fall on the selling shareholders, which would be unduly harsh since they would already be paying tax on the appreciation of their stock and would not enjoy the benefits of the step-up in basis of the corporation's assets.

Limitation on Dividends Received Deduction

Under the Staff's proposal, the minimum holding period for stock on which dividends paid would be eligible for the 85-percent dividends received deduction would be extended from 15 days to one year and the interest deduction on debt incurred to purchase or carry such stock would be virtually eliminated (85 percent of the deduction would be disallowed). TEI seriously questions the equity of the Staff's recommendations.

The dividends received deduction has historically served as a legitimate limitation to the multiple levels of taxation on streams of investment income between tiers of corporations. The 100-percent dividends received deduction (available only with respect to dividends paid within affiliated groups) operates to prevent the double taxation of intercorporate dividends completely. In contrast, the 85-percent dividends received deduction represents a 6.9 percent tax on other dividends received in the corporate sector. It was imposed years ago, mainly to discourage the setting up of multiple corporations by families or affiliated groups to claim multiple surtax exemptions and thereby reduce tax liability. Under the Tax Reform Act of 1969, however, multiple surtax exemptions and the intercorporate dividend tax were eliminated for affiliated groups. In the aftermath of the 1969 legislation, nearly all tax policy observers have called for the elimination of the intercorporate dividend tax across the board. It has remained, apparently only because of the revenue consequence of eliminating it. Now, the Staff proposes to extend the adverse effect of double taxation and to greatly magnify it in certain situations.

TEI believes that the Staff's proposal represents an overbroad, unduly harsh reaction to limited situations in which leveraged investments in preferred stock may have led to abuse. Surely, a less radical, more limited remedy can be devised to prevent such occurrences.

In the first instance, the Staff's proposal seems to treat investments in common stock in the same manner as investments in preferred stock, even though the reported abuses have involved only investments in preferred stock or offsetting positions of preferred and common stock. Perhaps more important, the proposal ignores that there are legitimate business reasons for acquiring less than controlling interests in corporations without regard to tax consequences. To support its proposal, the Staff cites the argument that the dividends received deduction "distorts" investment decision making in favor of stock against debt. It ignores, however, the much greater bias against equity investment posed by the double taxation of dividends at the corporate level and again at the individual shareholder level.

Furthermore, if the holding period were lengthened so that the deduction would become totally unavailable for dividends on stock held for less than one year, equity would require that a 100-percent deduction be available for dividends received on stock held by corporations for more than one year. In fact, equity calls for a 100-percent dividends received deduction regardless of these situations.

Finally, TEI is concerned that the Staff's proposal might influence corporate investment decisions in favor of debt rather than equity, which could have broad, unanticipated economic consequences.

Repeal of the Earnings and Profits Limitation on the Treatment of Corporate Distributions as Dividends

TEI believes that the Staff's proposal to eliminate the earnings and profits limitation on the treatment of corporate distributions as dividends is totally unsupportable. Most important, the proposal would undoubtedly lead to the taxation of capital. The Staff states that relief from this unwarranted tax would be available if the distributions (i) are made to contributing shareholders, (ii) are not in excess of the amount contributed, and (iii) are made within three years of the contribution. Such "relief," however, would be completely inadequate. We fail to see, moreover, how the relief provisions could be administered in the context of large publicly traded corporations that have tens of thousands of shareholders.

The Staff's proposal seems to be largely based on the contention that earnings and profits are difficult for both the Internal Revenue Service and taxpayers to compute. Ease in administration hardly seems a valid reason for such a radical change in our tax policy. Moroever, although the Staff proposes to eliminate the earnings and profits limitation for the purpose of determining the taxability of distributions, it states that the earnings and profits concept would be retained for other purposes (such as determining the deemed paid foreign tax credit). Thus, most large corporations which have foreign operations would still be required to make earnings and profits computations for non-U.S. subsidiaries while their shareholders (owners of a U.S. company) would be compelled to pay a tax on distributions, because of the difficulty of making such computations, even though those distributions could well represent the return of capital.

Special Limitations on Net Operating Losses

Finally, we would like to briefly comment on the Staff's proposals relating to the amendment of section 382 of the Code, which deals with limitations on net operating loss carryovers. The Staff contemplates two general sets of rules -- one dealing, in general, with the sale of stock of a loss corporation ("the purchase rule") and the other dealing with reorganizations ("the merger rule").

At this time, TEI takes no position with respect to these rules (including whether there should only be one rule to apply to all types of transactions), but we do wish to comment on one aspect of the purchase rule. Under the Staff's proposed purchase rule, net operating loss carryovers would be limited to an amount that the loss corporation could have utilized had no change of ownership occurred and had the loss corporation begun to earn taxable income at an assumed rate of return on the assets owned by it at the time of the change of ownership. (The rule would apply an assumed rate of return to the purchase price to determine the amount of losses that could be used.) TEI questions the validity of applying universal rates of return to corporations in varying industries. For example, the actual rate of return on assets for a corporation engaged in the manufacture of heavy equipment might be vastly different from the actual rate of return on assets of a pharmaceutical company. The myriad differences in corporations (their principal business, their size, their location, etc.) makes it extremely unlikely that an equitable purchase rule could be either drafted or administered.

Conclusion

As stated at the outset, TEI believes first and foremost that additional time is necessary to ensure that any legislation that is ultimately enacted is sound, not only on technical grounds but on tax and economic policy grounds as well. Our comments today reflect only our preliminary analysis of the Staff's proposal, and we stand ready to provide the Committee with additional assistance as the legislative process continues.

The CHAIRMAN. Again, I think I could say to both witnesses that this is a hearing on the report and that there was some interest in having the hearing.

We certainly share the view that, even though there have been years and years of study, that doesn't mean that everybody knows about it. Even if we had hearings for 2 weeks, I doubt that everyone would know about it.

But we are going to be working on legislation. We will be keeping in touch with those who have testified today and others who may have an interest, and we appreciate your assistance as we get into the legislation itself. Thank you.

Mr. COHEN. Mr. Chairman, may I just note one or two things? As we discuss in our statement, I am not quite clear about the business and economic effects of the proposals, about which lawyers may not be the best to judge. And I would share the view that the committee should seek the views of those that would be involved in the business aspects of the transactions.

I am concerned in the illustration I gave—of land and building in a corporation—that under these proposals, once they were in a corporation, they would be sold only to other corporations and would not come out into private individual ownership again, an aspect that would have an effect on the value of incorporated property.

The chamber is concerned that we should not put any restraints on the use of corporations as a means of engaging in business.

The **Chairman**. As I understand it, the chamber does support some aspects of the report.

Mr. **Cohen**. Yes.

The **Chairman**. I think when we get into the legislation we can deal with that. Again, I think we should have the business and economic input; but most business people I talk to are frightened, terrified, with the big deficits. They all want to make a contribution. At least that's what they tell me as I go around. As long as it doesn't affect them, they are willing to make a contribution. [Laughter.]

Mr. **Maletta**. We have to worry about our own deficits, Mr. Chairman, sometimes.

The **Chairman**. Not as much as you should worry about ours. If we double the national debt between now and 1989 it's not going to help anyone in this country.

Are you ready to proceed here in the order that you were named? Or you can proceed in any other order you may wish to proceed. I understand Mr. Bacon will be speaking rather than Mr. Tomasulo.

We will start with Mr. Nad.

STATEMENT OF LEON M. NAD, NATIONAL DIRECTOR, TECHNICAL TAX SERVICES, PRICE WATERHOUSE, NEW YORK, N.Y.

Mr. **Nad**. Mr. Chairman, since most of what I would have to say is in the record and as one or another of the previous speakers have covered the position of Price Waterhouse, I won't go into that anymore.

The **Chairman**. In other words you will just submit your written statement?

Mr. **Nad**. Yes.

[The prepared statement of Mr. Nad follows:]

COMMITTEE ON FINANCE
UNITED STATES SENATE

HEARINGS ON THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS

SUMMARY OF VIEWS ON MAJOR ISSUES

LEON M. NAD
NATIONAL DIRECTOR OF TECHNICAL TAX SERVICES
PRICE WATERHOUSE

OCTOBER 24, 1983

Price Waterhouse

INTRODUCTION

Attached is a summary of the views of Price Waterhouse on the major issues to be considered at the hearing on October 24, 1983, of the Committee on Finance of the United States Senate on reform and simplification of the income taxation of corporations. In view of time constraints, it has been possible to present herein only a brief summary of our views on major areas listed for discussion.

Our firm will shortly submit to the Committee in support of the positions taken herein a memorandum based on the wide experience Price Waterhouse has with the tax concerns of American business.

This summary takes into account, and our detailed memorandum will take into account, the preliminary report (S. Prt. 98-95) submitted to the Committee on Finance on September 22, 1983, by its staff.

Price Waterhouse

GENERAL UTILITIES REPEAL

We believe that further study is needed before it can be concluded that General Utilities should be repealed outright. In any event, should Congress conclude that outright repeal is called for, Price Waterhouse recommends that one of the five options listed on page 65 of the staff report should be enacted as a relief measure. It occurs to us that it may in fact be appropriate in some instances to permit an election as between two or more of these options.

DIVIDENDS RECEIVED DEDUCTION

We have concluded that any changes in the present treatment of the dividends received deduction is unwarranted.

The staff report (pages 47-48) deals with several alleged abuses. We discuss only two of these here, since in our experience the techniques described under "Offsetting Common and Preferred Stock" on page 47 are uncommon.

Price Waterhouse believes that it is inappropriate to restrict deductions for interest on borrowings made by a corporation to acquire preferred stock. If such a rule were enacted, it would produce an anomalous result; namely, that a corporation would be entitled to a deduction for interest incurred to produce no income (e.g., to pay a dividend) while it loses 85 percent of a deduction which produced dividend income taxable at 6.9 percent. Furthermore, it would discriminate against domestic, as opposed to foreign, investments; for example, when a corporation borrows to acquire stock of a foreign subsidiary, entitling the recipient to the deemed foreign tax credit (Code section 902).

We also consider it unnecessary to extend to one year the minimum holding period for stock on which dividends paid would be eligible for the dividends received deduction. This deduction is allowed to mitigate, but not eliminate, potential triple taxation of corporate earnings. To achieve that objective, any holding period requirements should be extremely short. This being so, Price Waterhouse objects to any tightening of the current rules.

Finally, we believe Congress should not require that amounts paid on stock sold short in lieu of dividends be treated as an increase in the basis of the stock rather than deducted. The result in Rev. Rul. 62-42 is sound. When a dividend is paid in these circumstances, it is not paid to acquire the stock; that acquisition is made, and that cost is determined, only when the short sale is closed. The dividend is not paid by the taxpayer to the party from whom the stock is purchased; it is paid to the person who has lent the stock which has been sold short, and is therefore an investment expense.

REPEAL OF EARNINGS AND PROFITS LIMITATIONS

Our firm believes that the repeal of the earnings and profits limitations on dividend distributions is unwarranted. It is a fundamental concept of any income tax that that it should not tax capital. Despite this, the proposal in the staff report (pp. 77-78) provides only an extremely narrow set of conditions under which there could be a distribution that would constitute a return of capital.

Under the "3-year, contributed capital (less after-tax taxable income) returned to contributor" concept a shareholder could receive taxable dividends even if the corporation has a deficit under any basis of computation. A distribution within the 3 years might be taxed differently to different recipients. Questions arise; e.g., would a successor in interest, such as an acquiring corporation or an estate, be deemed the contributor of capital made by another?

Accordingly, we urge that the earnings and profits concept not be abandoned solely for this one purpose. If careful study reveals significant abuse (and we are not certain that it will), consideration could be given to the alternative proposal listed on page 78 of the report and other appropriate measures. However, we do not agree that pre-1913 earnings and profits should be taxable.

ACQUISITIONS

Fundamental aspects

The staff justifies the electivity features of its proposal on the basis that electivity in fact exists now, but only for those who can employ skilled tax practitioners to achieve it. Through its proposals the staff concludes that implicit electivity can be made explicit and thus more generally available.

The question, however, is whether the current reorganization provisions permit nonrecognition with carryover of basis and tax attributes too freely, not freely enough, or appropriately.

The reorganization provisions of Subchapter C are, of course, exceptions to the usual rule that realized gain will be recognized and taxed currently. The justification for the nonrecognition rules now in force is that Congress has deemed certain business combinations to be merely formalistic changes which should not occasion a current tax.

The proposal does not attempt to analyze whether the conceptual underpinnings for the present reorganization rules are valid. Instead, it assumes that the present rules would necessarily remain in place, subject to only minor amendments from time to time.

We doubt that Congress can avoid an analysis of whether certain business combinations should be afforded nonrecognition; e.g., combinations designed primarily to achieve a diversification of investment. Since the 1954 Code's enactment there have been two anti-diversification Code amendments.

(a) "Anti-Centennial Fund" legislation - §351(e)(1)

(b) Investment Company mergers - §368(a)(2)(F)

Recently the Service issued a revenue procedure in which it states that it refuses to rule whether so called "energy roll-ups" qualify under §351. The difficulty perceived by the IRS is that these transactions do not literally fit within the "Anti-Centennial Fund" legislation, although they seem to violate its spirit.

Will the proposal allow nonrecognition election with respect to transactions primarily designed to achieve investment diversification? The goal of simplicity seems to require an affirmative answer. However, if investment diversification through corporations is freely permitted, will this not be perceived as an unfair by individual investors? For example, it could then be logically contended that an investor should be able to avail himself/herself of §1031 nonrecognition benefits on an exchange of portfolio.

In short, careful study should be given as to which, if any, business combinations should be excepted from the electivity feature. This consideration will necessarily involve giving thought to the conceptual justification for the present nonrecognition rules.

Control Requirements

Under the proposal the provisions of §338 would generally be retained, although the purchase rules would be expanded so that not only corporations, but individuals, partnerships, and trusts could make qualified purchases of a controlling interest in the Target. Section 337 would not apply to the Target's hypothetical sale, and Target would be deemed to have sold its assets in a taxable sale. The shareholders of Target would recognize gain or loss except to the extent that they sold stock in a purchasing corporation.

Under the circumstances, one wonders why the proposal holds to the 80 percent control requirement of §368(c). This requirement may well be criticized as bearing no relationship to any commercially recognized standard. A more realistic definition would, we believe, contemplate only perhaps 66 2/3 percent (2/3) control.

COMMITTEE ON FINANCE

UNITED STATES SENATE

HEARINGS ON THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS

VIEWS ON
REPEAL OF GENERAL UTILITIES DOCTRINE, ACQUISITIONS, DIVIDENDS RECEIVED DEDUCTION, AND REPEAL OF EARNINGS AND PROFITS LIMITATIONS

(A Supplement to the Summary of Views on Major Issues Submitted on October 24, 1983)

PRICE WATERHOUSE

NOVEMBER 2, 1983

Price Waterhouse

PRICE WATERHOUSE

VIEWS ON REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS

SUMMARY

Price Waterhouse commends the Committee staff for its efforts to provide a preliminary report on changes in the structure of corporate income taxation.

However, we believe that more careful study is needed of some of the current proposals. Various problem areas are noted below.

Price Waterhouse

REPEAL OF GENERAL UTILITIES DOCTRINE

Price Waterhouse believes that the Staff Report proposal to limit further the General Utilities doctrine is unwarranted. Distributions to stockholders are capital transactions, not income-generating ones. The Staff Proposal is particularly objectionable in its application to a distribution in complete liquidation of a corporation where many years' appreciation may be reflected in the value of the assets distributed. Furthermore, despite its analysis of the underlying rationale for repealing General Utilities, the Staff Proposal makes no provision for recognition of losses on a distribution of depreciated property. If, however, Congress should decide to limit further the doctrine of General Utilities, relief from resulting double taxation of gain at both the corporate and shareholder levels would be unjustifiably harsh. In many cases, the combined effective rate of tax paid by the corporation and the shareholders would exceed twice the 20 percent capital gain tax paid at the shareholder level under present law. Any increase of such magnitude clearly violates the concept that taxation should play a relatively neutral role in the choice of the form of doing business.

In our view, the most equitable and practicable mechanism for mitigation of potential double taxation is the granting of a tax credit to the shareholders for taxes paid by the corporation. We recognize however, that this approach presents various problems, most importantly determining the manner in which the credit would be calculated and allocated among different shareholder classes. Nevertheless, we believe this problem can be solved; the experience of other countries might be instructive in this context.

In connection with our consideration of the double taxation issue it has occurred to us that it might in fact be preferable if an election could be made under the credit approach whereby the corporate level tax would be forgiven to the extent that assets received by the shareholders took a substituted basis equal to the shareholders' basis in their stock. Indeed, further review of the double taxation issue may well reveal that more than one alternative for mitigation could be offered on an elective basis.

ACQUISITIONS

In our summary memorandum, presented on October 24, we urged careful study in order to determine whether any particular business combinations should be excluded from the selectivity features of the staff proposal. We continue to believe such a "front end" study to be appropriate. Many of the present complexities in the definitional approach of section 368 arose because of hastily drafted additions. The absence of final regulations under section 368(a)(2)(E) more than a decade after its enactment forcefully points out the need for a comprehensive statute.

In addition to considering whether certain transactions should be carved out of the selectivity rules, consideration should be given to how these rules will operate with respect to target corporations coming out of Title 11 bankruptcy proceedings. Thus, for example, present section 368(a)(1)(G) provides for non-recognition at the corporate level to an insolvent corporation provided that at least some of the security holders (long-term creditors) take an equity position in the acquiring corporation. Section 108 mandates "cut downs" in favorable tax attributes if creditors' rights are satisfied with consideration other than stock of the acquiring corporation. It is not clear what, if any, linkage would exist under the Staff Proposal between the survival of tax attributes and the nature of the consideration received by creditors. This important area of the tax law should be specifically and carefully addressed.

Shareholder Nonrecognition

The Staff Proposal states that shareholder treatment would be determined independently of corporate level nonrecognition. This is not wholly accurate. A shareholder in a corporation participating in an asset acquisition would be entitled to nonrecognition upon receiving stock in the acquiring corporation, but only if there were a "qualified acquisition" (i.e., an acquisition of substantially all of the target corporation's assets). In this regard, it should be noted that "substantially all" is not a precise concept. The IRS's ruling policy has long been that the requirement is met upon a transfer of ninety percent of the fair market of the target's net assets and seventy percent of its gross assets. Case law, however has found the "substantially all" requirement to have been complied with by a transfer of as little as fifteen percent of the net assets.

Presumably, under the Staff Proposal, the corporate level consequences of failing the "substantially all" test would be to transmute any carryover basis acquisition into a cost basis acquisition. However, it seems overly harsh to us to require a tax from shareholders of the target who took stock in the acquiring corporation in reasonable anticipation of nonrecognition treatment. The statute should allow nonrecognition to any such shareholder so long as the corporate parties had a reasonable basis to assume that substantially all the target assets had been acquired even though they may have been technically mistaken.

As noted above, nonrecognition will be afforded to a target corporation shareholder receiving stock in the acquiring corporation or stock of a parent, including stock of the lowest common parent when the target's assets are dispersed between two separate chains of affiliated corporations.

Initially, one wonders whether the target shareholders should not be allowed to receive stock both of an acquiring corporation and stock of its parent. This may be desirable to the shareholders if they anticipate future growth of a particular target division which will ultimately be lodged in a lower tier subsidiary of the acquiring group. Indeed, one wonders why any restriction should be placed as to which member of the acquiring affiliated group may issue its stock as "qualified consideration". The concerns exhibited by the examples IV-19 and IV-20 (Staff Report p. 62) seem vestigial manifestations of notions as to continuity of business enterprise and continuity of interest. If an acquiring corporation is, by virtue of eliminating continuity of business enterprise, free to transfer the assets it receives to its fourth-tier subsidiary which subsidiary then contributes such assets to a joint venture for a 10 percent partnership interest, it should make little difference which acquiring affiliated corporation's stock is received by the shareholders of the target corporation.

Example IV-22 in the Staff Report (p. 63) sets forth a situation in which boot received by a shareholder of a merged target corporation is entitled to capital gain treatment. What would be the result if such shareholder had realized an overall loss? Currently, section 356(c) would preclude loss recognition. However, if shareholder treatment is truly to be determined independently from corporate level treatment, then such a loss should be recognized.

Incorporation Transfers

Under the Staff Proposal securities could be received tax-free in an incorporation only if their principal amount does not exceed the basis of the property transferred in. Consideration should perhaps be given to using present value rather than principal amount in this context.

Selectivity and the exception for acquisition premiums

We generally favor the exception described in the Staff Report (p. 58) for purchase premium. We are concerned, however, that this exception could constitute a trap for the unwary purchaser who assumes that any premium will automatically be deemed a purchase of goodwill. Specifically our concern is generated by cases such as VGS Corp. 68T.C. 563 (1977), and Concord Control, Inc., T.C. Memo, 1976-301 and 78 T.C. 742 (1982), wherein a finding of going concern value led to a reduction in the depreciable basis of tangible assets below their admitted fair market value.

We believe that such pitfalls should be eliminated. The exception should specifically state that any unallocable premium is presumptively deemed a payment for goodwill.

DIVIDENDS RECEIVED DEDUCTION

We have concluded that any major change in the present treatment of the dividends received deduction is unwarranted.

The Staff Report (pp. 47-48) deals with several alleged abuses. We discuss only two of these here, since in our experience the techniques described under "Offsetting Common and Preferred Stock" on page 47 are uncommon.

Price Waterhouse believes that it is inappropriate to restrict deductions for interest on borrowings made by a corporation to acquire preferred stock. If such a rule were enacted, it would produce an anomalous result; namely, that a corporation would be entitled to a deduction for interest incurred to produce no income (e.g., to pay a dividend) while it loses 85 percent of a deduction which produced dividend income taxable at 6.9 percent. Furthermore, it would introduce a restriction in the area of domestic, as opposed to foreign, investments; for example, when a corporation borrows to acquire stock of a foreign subsidiary, entitling the recipient to the deemed foreign tax credit (Code section 902). See attached Exhibit I.

We also consider it unnecessary to extend to one year the minimum holding period for stock on which dividends paid would be eligible for the dividends received deduction. This deduction is allowed to mitigate, but not eliminate, potential triple taxation of corporate earnings. To achieve that objective, any holding period requirements should be extremely short. This being so, Price Waterhouse objects to any substantial extension of the holding period currently required.

Finally, we believe Congress should not require that amounts paid on stock sold short in lieu of dividends be treated as an increase in the basis of the stock rather than deducted. The result in Revenue Ruling 62-42 is sound. When a dividend is paid in these circumstances, it is not paid to acquire the stock; that acquisition is made, and that cost is determined, only when the short sale is closed. The dividend is not paid by the taxpayer to the party from whom the stock is purchased; it is paid to the person who has lent the stock which has been sold short, and is therefore an investment expense. One is forced to wonder, if interest were paid to the short seller on the proceeds of the short sale, whether there would be a proposal to treat such interest as a reduction in the basis of the stock acquired to close the short sale.

REPEAL OF EARNINGS AND PROFITS LIMITATIONS

Our firm believes that the earnings and profits limitations on dividend distributions ought not to be repealed. It is a fundamental concept of any income tax that it should not tax capital. Despite this, the proposal in the Staff Report (pp. 77-78) provides only an extremely narrow set of conditions under which there could be a distribution that would constitute a return of capital.

Under the "3-year, contributed capital (less after-tax taxable income) returned to contributor" concept a shareholder could receive taxable dividends even if the corporation has a deficit under any basis of computation. A distribution within the 3 years might be taxed differently to different recipients. Questions arise; e.g., would a successor in interest, such as an acquiring corporation or an estate, be deemed the contributor of capital made by another?

Accordingly, we urge that the earnings and profits concept not be abandoned solely for this one purpose. If careful study reveals a significant abuse (and we are not certain that it will), consideration could be given to the alternative proposal listed on page 78 of the Report and other appropriate measures. However, we do not agree that pre-1913 earnings and profits should be taxable.

EXHIBIT I

UTILIZATION AGAINST INCOME TAX ON OTHER FOREIGN SOURCE INCOME OF EXCESS FOREIGN TAX CREDITS ATTRIBUTABLE TO INTEREST ON FUNDS BORROWED

Assumption:

Corporation A owns all the stock of B Limited, incorporated in Country X, which imposes a corporate income tax of 50%. On January 1, 1983, Corporation A, which has no other interest-bearing debt, borrows $100,000 at 10% interest per annum to finance the purchase of a like amount of 9% cumulative preferred stock of B Limited. A also receives patent royalties of $25,000 annually from C Company, incorporated in Country Z. No Country Z tax is withheld from the royalties or dividends.

Case A. Federal income tax consequences without regard to royalty.

1.	Dividend received		$ 9,000
2.	Section 78 "gross up"		9,000
3.	"Grossed up" dividend		$18,000
4.	Federal income tax on above amount at 46%		$ 8,280
5.	Foreign tax credit earned - same as line 2	$ 9,000	
6.	Limitation on foreign tax credit:		
	Net income from foreign sources ($18,000 (line 3) - $10,000 (interest))	$ 8,000	
	Limitation - 46% of above		

EXHIBIT I
Page 2

	amount	3,680
7.	Net U.S. tax	$ 4,600

Case B. Federal income tax consequences considering royalty

1.	Dividend received		$ 9,000
2.	Section 78 "gross up"		9,000
3.	"Grossed up" dividend		$18,000
4.	Royalty		25,000
5.	Total foreign source income		$43,000
6.	Federal income tax on above amount at 46%		$19,780
7.	Foreign tax credit earned - same as line 2	$ 9,000	
8.	Limitation on foreign tax credit Net income from foreign sources ($18,000 (line 3) + $25,000 (line 4) - $10,000 (interest)	$33,000	
9.	Limitation on foreign tax credit - 46% of above amount	$10,580	
10.	Credit allowable - lesser of lines 7 and 9		9,000
11.	Net U.S. tax		$10,780

Conclusion:

Case B differs from Case A only in that foreign-source royalties (or $25,000) are considered. The additional tax on these royalties is $6,180 ($10,780 - $4,600), not $11,500 (46% of $25,000). The reason is that because of interest incurred to produce dividend income which is completely (not merely 85 percent) exempt (in the sense of there being no tax to the corporate recipient of the income) the taxpayer generates excess foreign tax credits available for offset in full against the federal income tax on other foreign source income.

The **Chairman**. Mr. Berenson.

STATEMENT OF DAVID A. BERENSON, ERNST & WHINNEY, WASHINGTON, D.C.

Mr. **Berenson**. I'm David Berenson, and I'm the partner in charge of Washington National Tax Services for Ernst & Whinney.

I would like to commend the chairman and the staff for bringing this long overdue review of subchapter C to the table. Of the staff's specific proposals, the one we felt was deserving of the most consideration was the universal recapture aspects of repealing the doctrine of General Utilities.

Accordingly, my brief oral comments will be directed toward this proposal, although we have responded to the chairman's questions and responses to other parts of the staff report are available in our written testimony. Basically, we support a great many of the proposals by the staff.

However, given the fact that the committee is reviewing the reform, and simplification of the Federal corporate tax structure, which we consider meritorious, and given the fact that it is our belief that there is an inherent structural defect in our corporate system which has caused most of the problems that we are dealing with; namely the differentiation in tax treatment of corporate distributions at the shareholder level and in the determination of earnings and profits, it is our recommendation as a policy proposal that all subchapter C corporate distributions be treated as deemed capital transactions, subject to capital gain and new individual alternative minimum tax treatment. The adoption of this policy would permit support of the phase-in of the staff's meritorious proposal on universal recapture under the repeal of General Utilities.

In effect, we find that like transactions are not taxed alike—a serious tax policy flaw. Certain corporate distributions are taxed at zero percent as returns of capital, some at 50 percent as dividends and some at 20 percent as capital gains.

Basically, if you eliminate those factors that create these variations, along with the earnings and profits concept, we feel you will have achieved substantial simplicity and reform. In essence, the adoption of this proposal, we feel, gives cognizance to the fact that taxpayers can structure their affairs right now to avoid the detriment of ordinary dividend transactions and cash out eventually at capital gains.

And by accepting an approach along this line which in substance is a modified integration approach, I think we are following the congressional mandate. Further, our proposal will increase the acceptability of the staff report and recommendations; will provide a significant reduction in present complex tax litigation; will reduce the present bias in favor of debt capital in the United States; will eliminate or enable the partial repeal of 13 code sections; substantially get us out of the morass of section 385 debt-equity concerns; reduce the bias in favor of retention of corporate earnings; and also place the United States in a more competitive position with respect to the integrated tax rates of our major trading partners, which we do not achieve at our present 73-percent maximum integrated corporate/shareholder rate.

[The prepared statement of David A. Berenson follows:]

STATEMENT OF DAVID A. BERENSON

THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS

ERNST & WHINNEY

I. Deemed Capital Transaction Proposal

Summary

We commend the Committee's review of the entire subchapter C area with a view toward its reform and simplification. We agree that the present laws governing the Federal income taxation of corporations and their shareholders have become unnecessarily complex and contain abuses and unintended hardships which should be eliminated.

Substantial tax incentives exist for certain types of corporate-shareholder transactions. These incentives arise primarily from an inherent structural defect in our present system of corporate income taxation. There are two fundamental factors involved in this structural defect: (1) rate variances, ranging from 0 to 50 percent, on corporate distributions at the shareholder level; and (2) the determination of earnings and profits ("E&P") upon which the characterization of such corporate distributions depends. Eliminate both of these factors and substantial reform and simplification will be accomplished, especially if the distinctions among return of capital, capital gain, and dividends are minimized.

We therefore recommend, as a substantive policy proposal, that:

> ALL DOMESTIC SUBCHAPTER C CORPORATE DISTRIBUTIONS BE TREATED AS "DEEMED CAPITAL TRANSACTIONS", AND BE SUBJECTED TO LONG-TERM CAPITAL GAIN AND ALTERNATIVE MINIMUM TAX TREATMENT, COUPLED WITH THE ELIMINATION OF E&P.

This proposal does not envision that such Deemed Capital Transaction could be offset by capital losses or otherwise be considered gain from the sale or exchange of a capital asset. Similarly, corporate recipients will still qualify for the dividends-received deduction. In making this proposal, we understand that there is no way in our enormously complex economic structure to construct a perfectly consistent, simplified, yet equitable, system of income taxation.

We respectfully submit that the adoption of this major policy proposal would most effectively accomplish each of the Committee's primary goals of reform and simplification of the present rules governing the Federal income taxation of corporations and their shareholders.

We further submit that this policy proposal has the far broader effect of substantially reducing the multiplicity of tax-motivated transactions and gives cognizance to the fact that well-advised taxpayers may presently structure their corporate affairs to avoid the detriment of ordinary dividend treatment in favor of ultimately more favorable capital gain treatment.

This Deemed Capital Transaction proposal will have the additional beneficial effects of:

1. Increasing the acceptability of the Staff's proposal for the repeal of the General Utilities doctrine;
2. Providing a significant reduction and elimination of certain issues that have given rise to a disproportionate amount of tax litigation;
3. Substantially reducing the bias in favor of debt financing over equity investment;

4. Potentially eliminating section 385 and repealing or amending at least 13 complex sections of the Code;

5. Substantially reducing the bias in favor of corporate retention of earnings;

6. Placing the United States in a more competitive posture for the attraction of worldwide capital; and

7. Stimulating capital mobility and utilization.

Discussion

This Deemed Capital Transaction proposal is compatible with the assumptions underlying the Staff's preparation of its Report.* This policy proposal has the effect of imposing a lower rate of tax upon distributions currently designated as "dividends." This results from the basic policy changes contained in this proposal which have broad substantive and adminstrative impact.

As previously noted, the primary problems in the existing system of corporate-shareholder taxation arise from the fact that a corporate distribution may be classified as a return of capital, capital gain or a dividend. Each of these has significantly different Federal income tax consequences, ranging from zero tax on a return of capital distribution to a maximum 50 percent tax on dividends, thus resulting in extensive tax planning.

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* Staff of the Senate Comm. on Finance, 98th Cong., 1st Sess., The Reform and Simplification of the Income Taxation of Corporations (Preliminary Report) (Comm. Print 1983). All parenthetical page citations in this submission are to pages in this Preliminary Report, hereinafter referred to as the "Staff Report."

Many of the distinctions between the treatment of these distributions arise from the concept of E&P. The Staff Report (p.77) and the ALI Report** recommend elimination or substantial extension of the E&P definition so that more distributions would be classified as dividends, subject to tax at ordinary income tax rates.

As the ALI Report admits, this would further exacerbate the problem of double taxation inherent in our current tax system (ALI Report, p. 519). Thus, the Staff's approach, while perhaps reducing the need to distinguish the type of distribution, would still encourage the taxpayer either to refrain from making distributions or to enter into transactions designed to avoid having a distribution characterized as a "dividend."

We agree with the Staff that E&P is an unduly complex concept (p. 102) which, from our experience, has proven to be administratively out-of-hand in many instances. Our Deemed Capital Transaction proposal would entail the repeal of the E&P concept and would eliminate the return-of-capital concept except for stock redemptions and sale or exchange transactions.

For many years, various proposals to solve these problems and to reduce double taxation of corporate earnings by integration at the corporate and shareholder level have been studied. (See, for example, Federal Tax Division of the American Institute of Certified Public Accountants, Elimination of the Double Tax on Dividends (Statement of Tax Policy No. 3) (AICPA, 1976).) While some integration proposals have

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** American Law Institute Federal Income Tax Project--Subchapter C, Proposals on Corporate Acquisitions and Dispositions (1982) (hereinafter referred to as "ALI Report.")

found more theoretical justification than others, they generally seem to suffer from operational and administrative complexity. The Deemed Capital Transaction proposal is not a pure integration approach, but it reaches substantially the same goal of reducing double taxation in a more simplified manner.

One of the more controversial proposals contained in the Staff's Report is the suggested repeal of the doctrine of General Utilities, 296 U.S. 200 (1935). The Deemed Capital Transaction proposal creates a more receptive environment within which to effect such a repeal. Our proposal is in keeping with recent congressional consideration of action to broaden the tax base, under the theory that a broad-based low-rate Federal income tax is generally more desirable than a narrow-based high-rate tax.

Several economic benefits could be realized from adopting such a policy proposal. For instance, it is known that high tax rates produce a bias toward the corporate retention of earnings. The Deemed Capital Transaction proposal will permit corporations to adopt a more tax-neutral dividend policy by lessening the pressure for corporations, especially closely held ones, to refrain from making dividend distributions in order that shareholders may subsequently "cash-in" at capital gain rates.

The substantial increase in earnings made available to shareholders as a result of the adoption of this policy proposal will stimulate increased forms of capital utilization, some of which will be attracted to equity-seeking new ventures. Thus, a better after-tax return for the inherent risk of equity investments should encourage the formation of more equity capital. It should be remembered that new section 128 (Partial Exclusion of Interest) already provides for an annual exclusion of up to $900 of interest income (on a joint return), beginning in 1985, thus further increasing the bias in favor of investment in debt rather than equity positions.

Another economic benefit of the adoption of the Deemed Capital Transaction proposal is that it would place the United States in a more competitive posture in worldwide capital and product markets. Many of our major trading partners (e.g., Canada, United Kingdom, West Germany, Japan) presently have a form of integration in their tax system. In this respect, domestic corporations are currently at a competitive disadvantage because of the more attractive financial inducements overseas. Our policy proposal would reverse this disadvantage by making the United States more attractive to capital investment.

The tax disparity between financing corporations by interest-paying debt or dividend-paying stock, when viewed from the combined tax at the corporate and shareholder levels, would be reduced under this proposal, thus producing another economic benefit. Because interest is generally tax deductible to the corporation, the maximum combined corporate-creditor tax rate for debt-financed earnings is 50 percent. On the other hand, earnings generating dividends are taxed at a combined corporate-shareholder rate of up to 73 percent, i.e., the 46 percent corporate rate plus 27 percent (50% x 54%) on the residual (assuming all after-tax earnings are paid out). If our proposal were adopted, however, the disparity between debt and equity financing would be reduced to a 6.8 percent differential [50% v. 56.8% (46% corporate rate plus 10.8% (20% x 54%))].

The foreign systems noted above produce an approximate maximum combined corporate-shareholder tax rate on distributed earnings as follows:

Canada	60%
United Kingdom	62%
West Germany	56%
Japan	56%

Thus, our policy proposal to reduce the maximum comparable United States rate to 56.8 percent would place us in a far more competitive posture vis-a-vis some of our major trading partners, since it would now be in the above range.

Our proposal also would alleviate some of the incentive for "thin" capitalization, since the impetus for classifying capital as debt rather than equity would be reduced. Consequently, the need for provisions such as section 385 and the controversial regulations that were proposed thereunder would be considerably diminished. Reducing the high tax benefit of corporate debt, which our substantial experience in the bankruptcy area has shown to be a prime cause of financial difficulty to both small and large businesses, would lead to a better allocation and use of resources.

The entire simplification of the structural and substantive problems of subchapter C, which historically have given rise to a major percentage of tax litigation, would be greatly assisted by our policy proposal. Thus, all questions of "dividend equivalence," even outside of subchapter C, would be eliminated. "Boot" in reorganization transactions would be taxed at capital gain rather than at ordinary income tax rates, thus alleviating minority or non-electing shareholders in takeovers from adverse consequences. The issue in Shimberg, 577 F.2d 283 (5th Cir. 1978), would be resolved quite simply.

We recognize that the policy proposal could have a significant revenue impact. Using currently available statistics of income data (1980), we estimate that the revenue reduction would be in the vicinity of $10 billion. For several reasons, however, we believe this reduction in fiscal revenues would be subject to substantial or complete offset.

The primary offset would result from the revenue-raising implication of additional corporate distributions. Further, to preserve an orderly transition in capital markets and to minimize the revenue impact, the extension of long-term capital gain treatment to a Deemed

Capital Transaction could be phased in over three years. The extension of long-term capital gain treatment to a Deemed Capital Transaction would necessarily require that 100 percent of the long-term capital gain deduction be included in the new individual alternative minimum tax computation. Similar conformity would be required with respect to the limitations under section 172(d) on the generation of losses. Any portion of the distribution not included in taxable income would not be investment income for purposes of section 163(d). During the phase-in period, to the extent additional revenues from increased corporate distributions do not materialize, simplified mechanisms are available for strengthening the alternative minimum tax. Moreover, any revenue implication applicable to changes in the General Utilities doctrine should also be considered. We have not attempted to estimate that amount, but we believe it to be substantial.

The Staff suggests that E&P as a concept would remain relevant in the foreign area (p.77). As stated previously, the application of our Deemed Capital Transaction proposal is limited to domestic corporations. While we believe, however, that it might be possible to eliminate the use of the E&P concept in the foreign area by converting the section 902 deemed credit into a dividends-received-deduction approach based upon weighted statutory rates. We would retain the section 901 credit for foreign withholding taxes as a direct credit. We agree with the Staff, however, that this subject deserves further study.

Finally, if our policy proposal is adopted, the following Code sections could be repealed or substantially simplified:

Section 116 -- Partial Exclusion of Dividends and Interest Received by Individuals

Section 301 -- Distributions of Property

Section 302 -- Distributions in Redemption of Stock

Section 303 -- Distributions in Redemption of Stock to Pay Death Taxes

Section 304 -- Redemption Through Use of Related Corporations

Section 305 -- Distributions of Stock and Stock Rights

Section 306 -- Distributions of Certain Stock

Section 312 -- Effect on Earnings and Profits

Section 316 -- Dividend Defined

Section 341 -- Collapsible Corporations

Section 356 -- Receipt of Additional Consideration

Section 385 -- Treatment of Certain Interests in Corporations as Stock or Indebtedness

Section 531 -- Imposition of Accumulated Earnings Tax

Section 541 -- Imposition of Personal Holding Company Tax

II. Responses to Senator Dole's Questions

QUESTION: IF GAIN IS TAXED TO THE CORPORATION ON THE DISTRIBUTION OF APPRECIATED PROPERTY, IS ANY RELIEF APPROPRIATE EITHER ON A TEMPORARY OR PERMANENT BASIS? IF RELIEF IS CONSIDERED NECESSARY, HOW SHOULD IT BE STRUCTURED?

RESPONSE: It is our belief that the imposition of a tax on corporate gain arising from the distribution of appreciated property would only be appropriate in conjunction with the implementation of our Deemed Capital Transaction proposal, coupled with a phase-in period and a deferral of the effective date to provide existing corporations with the ability to properly arrange their affairs. In the absence of the adoption of both the Deemed Capital Transaction proposal and the deferred phase-in period, the imposition of a tax upon corporate gain arising from the distribution of appreciated property, without permanent relief therefrom (preferably in the form of a substituted or carryover basis provision) would not be appropriate.

Section 303 redemptions should not be subjected to the imposition of such a tax under any proposal.

DISCUSSION: In conjunction with the adoption of the Deemed Capital Transaction proposal, we recommend that the acceptance of the Staff's proposed repeal of the current nonrecognition rule be accomplished over the phase-in period suggested by the Staff (pp. 65-66), preceded, however, by a five-year delay of the beginning of the phase-in period. The purpose of such a five-year delay would be to permit corporations a sufficient time span within which to cope with this totally new concept and to plan to arrange their affairs in a logical and orderly manner.

In the absence of the Deemed Capital Transaction proposal, we believe that each of the relief mechanisms contained in the Staff's Report deserve further comprehensive study. Our preliminary reaction is that either the substituted-basis or carryover-basis mechanism are preferable to the others enumerated. We feel that the substituted-basis mechanism would be the most effective of the available choices in that, it would, to the greatest extent possible, apply the ability-to-pay concept to in-kind distributions without offending the principle that an asset basis step-up to fair market value should not be free of tax.

We acknowledge that certain limitations on the substituted-basis relief mechanism may be needed. For example, the treatment of domestic corporate distributions to foreign shareholders should be studied. Other policy considerations may need to be reviewed with respect to tax-exempt shareholders.

In connection with the proposed repeal of section 341, certain unintended opportunities might arise. For example, stock of a "collapsible corporation" could be purchased at fair market value, followed by a substituted-basis liquidation that would result in a step-up of the assets to fair market value without recognition of the gain. This opportunity could be eliminated by providing that no substituted basis would be permitted for assets held by the corporation less than three years, including any net increase in inventory value during that period, leaving the corporation subject to full tax on the gain on such assets.

Unless an exception to the proposed repeal of General Utilities, 296 U.S. 200 (1935), is provided for section 303 redemptions, the combined impact of the estate tax and the corporate tax arising from in-kind distributions used to fund payment of the estate tax could effectively force the partial or complete liquidation of a closely held corporation.

QUESTION: WHETHER THE 85% DIVIDENDS-RECEIVED DEDUCTION, WHEN COUPLED WITH THE FULL DEDUCTIBILITY OF SHORT-TERM CAPITAL LOSSES, CONSTITUTES A LOOPHOLE OR PRESENTS UNINTENDED BENEFITS?

RESPONSE: We agree with the Staff that unintended benefits can arise when the 85 percent dividends-received deduction is coupled with the full deductibility of short-term capital losses.

DISCUSSION: The Staff has proposed that stock must be held for at least one year, rather than 15 days (or 90 days for preferred stock with arrearages in excess of one year) in order for dividends paid with respect thereto to qualify for the dividends-received deduction (p.78). The Staff also proposed that the rules for computing the holding period be tightened, and that amounts paid in lieu of dividends on stock sold short should be capitalized rather than deducted as an investment expense (p.79).

It is assumed that these proposals are not intended to affect the current rules applicable to a securities dealer's inventory.

A corporation should not be able to convert capital gain income into dividend income by entering into a transaction lacking investment motive. This was the reason that the 15-day and 90-day holding period rules for section 246 were enacted. Experience has indicated that these holding periods are too short. An extended holding period would be indicative of an investment purpose and tying it to the long-term capital gain holding period would not be unjustified. Any mechanism designed to limit economic exposure should toll the holding period.

We agree that a short sale of stock prior to the ex-dividend date, which generates an ordinary deduction and a corresponding short-term gain, is currently used as a tax planning tool and should be eliminated. We support the Staff's proposal to capitalize the payment with respect to borrowed stock.

By the nature of these proposals, the Staff has reiterated that the purpose of the 85 percent dividends-received deduction is to mitigate the impact of a nonintegrated corporate-shareholder tax system where the double level of taxation would otherwise expand to three or more full levels of taxation on corporate earnings and the distributions thereof. To further this mitigation and in view of the proposed extension of the holding period, we suggest increasing the dividends-received deduction from 85 percent to 100 percent.

QUESTION: IF, AS THE STAFF SUGGESTS, THE LIMITATION ON DIVIDEND TREATMENT OF DISTRIBUTIONS BY CORPORATIONS PROVIDES OPPORTUNITY FOR ABUSE, SHOULD THE EARNINGS AND PROFITS LIMITATION BE REPEALED OR SHOULD A NARROW SET OF REVISIONS TO THE RULES BE ATTEMPTED.

RESPONSE: Absent a major modification of our present system of corporate-shareholder income taxation, along the line we have suggested in our Deemed Capital Transaction proposal, we believe that perceived abuses arising from the earnings and profits ("E&P") limitation on dividends could more effectively be resolved by revisions to the existing rules.

DISCUSSION: Based on our long experience, we readily accede to the Staff's conclusion (p. 46) that E&P is an unduly complex concept; we believe that in many instances it is administratively out-of-hand. One of the most beneficial aspects of our Deemed Capital Transaction proposal would be the elimination of the E&P concept in a manner designed to substantially reduce the extensive tax-planning arising from the dramatically different tax consequences inherent in our present system of taxing "distributions" and "capital" transactions at greatly divergent rates.

As an administrative matter, it is already quite difficult, if not impossible, for many corporations to trace their E&P history to inception. This process becomes even more impossible where the necessity arises to take into account the E&P history of previously acquired, liquidated, or spun-off domestic corporations. This doesn't even begin to cope with the still unsettled E&P consequences of having acquired a foreign corporation in a tax-free manner.

Any proposal that would retain the E&P concept and extend it to include pre-1913 E&P will be totally incapable of effectuation. Appropriate records simply do not exist, either in the private or governmental sectors, to support calculations of pre-1913 E&P, except in relatively rare instances.

However, if it is decided to retain the current E&P concept, at least for the time being, we offer the following comments:

Restrictive rules for distributions of securities - The Staff has suggested (p. 78), that it is desirable to avoid reduction of E&P by the face amount of a "deep discount" note issued as a dividend. We agree. We suggest that section 312 be amended to deal with this issue by providing for the reduction of E&P only when payment is made on the note. Payments on the note would be taxable as dividend income regardless of to whom paid. However, further study is needed to determine whether such a note should be a capital asset, and to determine the appropriate adjustment rules in a consolidated return context.

Restrictive rules for redemptions - We feel that there is no need for change in this area. In Rev. Rul. 79-376, 1979-2 C.B. 133, the Internal Revenue Service agreed to follow Jarvis, 34 B.T.A. 439 (1942), presumably putting to rest earlier discord.

Restrictive rules for anticipatory borrowings - It has been suggested that an abuse exists in the situation in which a corporation with appreciated property, without either accumulated or current E&P, borrows against the appreciated property and distributes cash from the borrowings to its shareholders. To correct this perceived abuse would require a change in the basic realization/recognition concepts underlying the entire system of taxation in the United States. To borrow against appreciated property is not a realization event.

Restrictive rules for corporations with financial earnings - Quite clearly, the historical development of E&P has been outside of "financial earnings." If it is determined to retain an E&P concept, the introduction of a totally new definition thereof can only lead to far greater complications than currently exist today. The current concept of E&P, even with further amendment of the computational rules, must produce a more understandable result than would be obtainable under a new concept.

Moreover, the utilization of "financial earnings" as a replacement for E&P, and the understanding of the full impact of such use on the financial community and upon financial reporting, would require further exhaustive study. This study would have to take into account the effect, if any, that would derive from the rules and regulations of the Securities and Exchange Commission and pronouncements by the Financial Accounting Standards Board.

Inclusion of pre-1913 E&P - Whatever substantive merits might support this proposal, our experience as accountants clearly dictates that very few corporations in existence today have sufficient records to trace their E&P back to 1913, let alone prior thereto. While it is sometimes possible to obtain otherwise missing information from the Internal Revenue Service when necessary to complete an E&P study, the Service obviously does not have pre-1913 records of E&P available. If enacted, it would be totally impossible to comply with such a provision.

QUESTION: WHAT SPECIAL LIMITATIONS ON NET OPERATING LOSSES AND OTHER TAX ATTRIBUTES ARE DESIRABLE IN ACQUISITIONS?

RESPONSE: We suggest that no legislative changes be made to the net operating loss ("NOL") carryover rules presently in effect without thorough coordination of any such proposed changes (both from a policy and practical point of view) with the comprehensive changes (or any modified versions) proposed in the reorganization area. The comprehensive changes to both areas should only be enacted as a complete package. In addition, we suggest that a further postponement of the previously legislated changes is appropriate to permit proper evaluation of the Staff's recently introduced rate of return proposal limiting the use of NOLs and to formulate a comprehensive future policy on this subject in light of such proposal.

We agree that trafficking in NOLs should not be encouraged. Further, we agree with the Staff that the current limitations on NOLs may, under certain conditions, result in a disproportionate relationship between the economic investment made and the tax benefits obtained.

DISCUSSION: It is a generally accepted proposition that the rules governing the availability of NOL and other attribute carryovers should not unduly distort investment decisions. In view of the many subjective criteria that currently must be satisfied before any benefits can be obtained from an acquired NOL, the present rules fail to supply sufficient certainty. Further, the economic value of any corporate tax attribute should not change merely due to a change in the ownership of a corporation.

The Staff proposal (p.67) would continue to apply a different set of rules for different forms of ownership changes. While there appears to be greater theoretical uniformity underlying the purchase and merger rules, significant differences continue to exist. Most obvious, the purchase rule would fluctuate with the section 6621 rate, while the merger rule apparently would not. During periods of high short-term interest rates, the assumed rate of return on capital used in a purchase would permit greater utilization of NOLs. While such results may be proper if one assumes a desire to create incentives for acquisition borrowings during a high-interest-rate period, it would appear that such objectives are inconsistent with an overall objective of tax neutrality. Such differences also highlight the continuing need to evaluate business transactions from a tax point of view, i.e., the effect of the purchase versus merger rules on availability of NOLs.

Since the section 6621 rate is changed twice a year based upon an average of the predominant prime rate during the six months prior to the change, the proposed purchase rule will require the forecasting of future changes in the expected rate of return. Accordingly, potential purchasers can be expected to apply a greater discount in valuing the NOL. This will be to the disadvantage of sellers due to a buyer's inability to accurately forecast future interest rates.

It would be helpful if the proposed limitation dealt more directly with potential situations where the purchase and merger rules overlap or where the capital structure of the acquiring or acquired corporation is complex. For example, where the target has outstanding options, warrants, convertible-redeemable-participating preferred stock or other such financial instruments, or where the purchasing entity uses such instruments as consideration, legislative guidance for determining the percentage of target corporation stock acquired or acquiring corporation's stock issued is necessary.

It is uncertain as to how the merger or purchase rules would interact with the types of reorganizations designed to rehabilitate bankrupt or insolvent debtors. Rules relating to the proposed stock for debt exchange should be more specific in identifying which date is to be used in determining continually refinanced debt or trade credits. The purchase of a creditor's position by a third party with a view towards the ultimate conversion should be considered. Such considerations may give rise to the need for anti-abuse provisions, which by necessity will be subjective, thus continuing certain current difficulties.

QUESTION: SHOULD INACTIVE LIMITED PARTNERSHIPS WITH PUBLICLY TRADED PARTNERSHIP INTERESTS BE TAXED AS CORPORATIONS?

RESPONSE: We feel that it is inappropriate, as a matter of tax policy, to single out only one of the attributes of corporate identity, such as free transferability of interests, as the sole determining factor of whether an entity is to be taxed as a partnership or an association.

DISCUSSION: With respect to nonpublicly traded limited partnerships, the existing rules would continue to apply. The mere distinction of public or private ownership of interests in organizations that are otherwise similar does not appear supportable as the sole test for producing greatly different tax treatment of the respective entities. If it is felt that the rules for characterizing entities for Federal income tax purposes need changing, they should be examined in the light of an overall review of subchapter K. The inclusion of such rules in a revision of subchapter C is not efficient.

However, if any changes are to be made with respect to the characterization of publicly traded limited partnerships, some provision permitting the continued use of the partnership vehicle to effect a corporate liquidation is needed. Thus, a publicly-traded corporation should be permitted to liquidate into a publicly traded partnership that would be able to maintain partnership status until the earlier of when liquidation is completed or a specified time period (such as five years), whichever occurs first.

Corporate Reorganizations

With limited exceptions, and subject to review of actual statutory language, we endorse the Staff proposals for simplification of the corporate reorganization provisions. Such recommendations would, in large part, do away with many of the complications associated with current rules and permit a more rational and simplified approach in the structuring of business combinations. Thus, an outright elective policy for cost versus carryover basis would replace the current system in which such elections can in effect be made, but only through the design of complicated acquisition structures. Such outright electivity will permit a greater rationalization for the consideration used in business combinations, while avoiding much litigation, subjective standards and traps for the unwary.

While we are in general agreement as to the various principles which underlie the Staff proposal, we believe that review of such proposals would be necessary if the Committee were to determine that permanent or temporary relief is required with respect to the proposed repeal of General Utilities. Corporate reorganization provisions in which a cost basis is obtained should not give rise to a tax result that varies from the result obtained in an outright liquidation of the acquired entity.

As with any legislation of this magnitude and importance, a number of significant terms and concepts need to be defined more precisely and illustratively demonstrated. For example, current rules have long relied on the term "substantially all" in connection with sections 368(a)(1)(C), 368(a)(1)(D), triangular mergers, and 368(a)(1)(G). However, it is unclear as to exactly how "substantially all" is measured in each of these contexts. Further, the Staff's concept of an "unallocated acquisition premium" not giving rise to taxable income or basis adjustments should be more clearly amplified. For example, where an acquisition premium has been paid, the tax basis in a subsidiary will still be equal to only the net assets of such newly acquired entity if a carryover basis is utilized. It is unclear as to how gain or loss would be calculated if the stock of such subsidiary were sold in a subsequent unrelated event. Failure to permit such unallocated purchase premium to be included in basis would appear inappropriate.

We recognize that due to the entity by entity election of a cost or carryover basis for assets, opportunity for abuse may arise. However, we feel that within certain parameters, limitations on preacquisition restructurings could be enacted without unduly complicating the Staff's proposal. Further, as situations may arise in which more than a single corporation could use its stock as valid consideration in the same nonrecognition transaction, more precise rules as to the movement of corporate attributes under section 381 would be desirable.

While we agree that business transactions would best be served by allowing acquired corporations to elect a basis in assets that may or may not comport with the carryover or cost basis rules at the shareholder level, we believe that consideration should be given to the total repeal of the concept of dividend equivalence involving reorganization transactions with boot. The continued relevance of such dividend equivalence rules becomes blurred when viewing a system which no longer requires symmetry at the corporate and shareholder levels, drops the requirements contained in the current continuity of interest test, and substantially simplifies an important area of subchapter C. Further, such provisions are administratively difficult to enforce, spawn substantial litigation and yield minimal revenues. The continuation of the dividend-equivalence doctrine will retain current inconsistences between corporate taxpayers (who desire such dividend treatment due to the dividends-received exclusion) and that of individuals (who are taxed on such income at ordinary rates). With enactment of Wright, 482 F.2d 600 (8th Cir. 1973) many individual minority shareholders will be less concerned with the ability to show a lack of dividend equivalence. In order to best serve the interests of simplicity and in view of the enhanced ability of minority shareholders to obtain capital gain under the Wright approach, we urge the Committee to repeal the dividend-equivalence doctrine.

Under our Deemed Capital Transaction proposal, the concept of dividend equivalency as a test for boot would be eliminated.

Conclusion

We feel that our policy proposal has the ability to render major assistance to the Committee in the attainment of its goals for the review of subchapter C. We would be pleased to participate with the Committee, its Staff and all other interested and concerned parties in the further study and the development of legislation to accomplish our mutual goals of reform and simplification of what has become an overly complex area of our tax laws.

STATEMENT OF RICHARD L. BACON, ESQ., BELL, BOYD & LLOYD, WASHINGTON, D.C.

The CHAIRMAN. Mr. Bacon, you are next.

Mr. BACON. Senator, my name is Richard Bacon. My colleague Nicholas Tomasulo, and I, are former members of the joint committee staff who worked on corporate taxes.

On the subject of part of the staff report that deals with limitations on net operating losses after corporate mergers, many of us have worked on this subject in the American Bar tax section and feel—we agree with the basic aims of the staff proposals to close the loopholes in this area, but we think there are serious defects in some of the assumptions that the staff makes. And the fact that you have three different rules under the staff proposal will probably increase the administrative problems and the so-called merger rule could, in practice, create new abuses, which we probably would want to avoid.

A constructive alternative, we think, is the single rule that would provide that whatever amount a buyer pays for a company—whether he uses cash, notes or stock—that is the total amount of losses that the company would get, and no more.

That also gives us the certainty that Mr. Jacob spoke about in his testimony. And to prevent the sale of losses of dead businesses, we also suggest that you subtract cash and passive investments from the value of a lost company, and also business assets, which are put in shortly before a merger or sold off shortly after a merger.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statements of Richard L. Bacon and Nicholas Tomasulo follow:]

STATEMENT OF RICHARD L. BACON
BELL, BOYD & LLOYD, WASHINGTON, D.C.

Statement

Mr. Chairman and members of the Committee, my name is Richard L. Bacon. I am a lawyer in engaged in private tax practice in Washington as a partner in the law firm of Bell, Boyd & Lloyd. I am not appearing on behalf of any special interest or group. I was a member of the Joint Tax Committee Staff in 1976 and participated in developing the 1976 Act amendments to the loss carryover provisions for corporate mergers. During the past three years I have worked closely with colleagues on an American Bar Tax Section Subcommittee on loss carryovers. I chaired a task force within the Committee which was asked specifically to study the American Law Institute proposals which the Staff has borrowed for its recommendations on net operating loss carryovers. We studied the basic soundness of the approach used by the American Law Institute (ALI) and also, because of its extreme complexity, the question whether this whole scheme can be applied in a workable way to real life transactions.

We concluded -- and I speak here only for myself and for the individual views of the chairman of the Tax Section Subcommittee on Carryovers, Michael Wasserman -- that while the ALI proposals on loss carryovers move in the right direction in trying to close loopholes and prevent carryovers from being a primary factor in acquisitions, the specific mechanics which are proposed are over-theorized and excessively intricate. The danger is that we will fail to stop "trafficking" in losses if we go about it with rules of this kind that are so complex and try to achieve so many secondary theoretical objectives that they cannot be fairly easily applied by practitioners and revenue agents. I would also contend that some of the rules proposed by the Staff will not actually achieve the objectives they say they want to achieve. Such rules can and will inadvertently create new loopholes for tax abusers to exploit.

Uniform Purchase Price Rule As An Alternative

In my opinion, all the basic objectives of the Staff study (and of the American Law Institute proposal) can be better and more simply achieved through a single uniform "purchase price" rule. This alternative originated here in the Congress when it was suggested in 1958 by an Advisory Group on Subchapter C composed of distinguished tax practitioners. A professional colleague, Nicholas Tomasulo, who has also served as a member of the Joint Tax Committee Staff, and I have proposed a version of this purchase price rule in a recent issue of Tax Notes for September 12, 1983. This alternative will actually do a better job of carrying out the Staff's own basic objectives; it also avoids new types of abuse which I believe will open up if the

Staff proposal is adopted. The ALI Reporter has also recently circulated a memorandum in which he says that the purchase price rule would be an acceptable alternative.

Simply stated, I suggest we treat all mergers, stock purchases and other acquisitions as "purchases" of stock or assets, and limit carryover deductions to the dollar amount of the purchase price itself. This is a single, uniform rule which would apply to all forms of acquisition and to all forms of payment the buyer makes, whether in cash, notes, common stock, preferred stock, or any combination of these payments. If a buyer pays, say, $500,000 for the stock of a loss company, the company could thereafter use a total of only $500,000 of its loss carryovers from past years. The rationale is that at the time the deal is made, the buyer must take a hard look at the earnings potential of the loss company's assets in determining the amount he will pay for the loss company. The amount of this price will reflect a present value approximation of that earnings potential. Limiting the company's use of carryovers in the future under its new owner will target specifically on the earnings potential from the loss company's assets as if no sale had occurred. The new owner could therefore acquire no more carryovers than the parties judged the old owners would probably have been able to use against income their assets were likely to have earned. This judgment at the date of sale would fix the allowable amount of carryovers after the merger -- the total amount could not go up, or down, by tracing actual later earnings from the loss assets. At the same time, the amount of usable losses could not be manipulated upwards after the merger.

This limitation would thus be entirely neutral in neither encouraging nor discouraging an acquisition which the parties make for nontex reasons. Observe, too, that since the tax benefit from carryovers is only 46 percent at most, at least 54 percent of the purchase price must be paid for other nontax assets owned by the loss company. Thus, "shell" companies could not be sold and bought for their tax attributes alone. Indeed, the buyer in any case would have to pay more than half of his purchase price for business assets. To my mind, this result blocks all "trafficking" in loss and credit carryovers.[1]

Defects in the ALI/Staff Proposal on Loss Carryovers

In contrast with this single uniform rule, there are so many firecrackers going off in the ALI/Staff proposal that one hardly knows where to begin to describe it. There would be three different basic rules. One would limit carryovers after a taxfree merger, where common stock is issued, to a percentage of the surviving company's income annually. The percentage would be computed from an elaborate table to be added to the statute. Where preferred stock is issued in a taxfree merger, carryovers would be limited to the amount of dividends _actually_ _paid_ on the preferred stock. Finally, where outstanding stock is purchased for cash, notes or stock in a taxable transaction, carryovers would be limited to an _imputed_ _return_ _on_ the dollar amount of the purchase price paid for the stock. Under the last of these rules, the deemed rate of return would first be set by Congress (in some way which may or may not be accurate), and presumably would have to be varied periodically under a formula which would have to be provided. Yet, the aims of all this three-headed complexity is to end up basically with the same result as the simpler single rule will accomplish.

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[1] It must be emphasized that the buyer would not be allowed all the carryovers of the selling company unless all the carryovers were equal to, or less than, the amount of the purchase price. Otherwise, the company could use under its new owner only:

(a) a total of carryovers proportional to the earnings propects of the loss company's business assets at the date of sale, and

(b) the present value of that total amount.

To carry out the above Rube Goldberg machine, a vast array of separate and overlapping rules is needed. There will be a statutory table for computing a precise amount of income against which losses could be deducted after a merger, and special rules creating a deemed rate of return on a purchase price. We would have to apply both the return-on-purchase-price rule and the merger rule together in multi-part transactions and in cases where less than all of the loss company's stock is purchased. In other cases, where the rules overlap, the different rules must all be applied and the one which produces the lowest result would be chosen. New pressures will be placed on the need to distinguish common from preferred stock, and numerous new "special rules" would be created to classify hybrid securities and convertible shares. We would have to guard against manipulations based on artificially inflated dividend payments on preferred stock. Practitioners and agents would also have to look back from each carryover year to each of up to 15 old "loss years" and make comparisons based on stock ownership between each of these points, resulting in possibly up to 15 separate calculations each and every year.

There is so much complexity in this that I think it will prove more difficult to administer than present law. If and when that happens, loopholes increase rather than decrease for those who know how to exploit confusion and uncertainty, particularly among Internal Revenue agents. Enforcement is likely to break down and Congress' worthy objectives will be defeated out in the field.

Abuse Potential. Under the guise of theoretical "assumptions," the Staff proposal will permit a new owner in reality to use far more losses, and with effectively no limit on the annual rate of use, than the sellers would ever have achieved. A buyer, for example, who issues 10 percent of his common stock to the loss company's shareholders in a merger could use carryovers against an after-tax percentage of income each year keyed to 10 percent of each year's future earnings. However, the buyer can double the profits from his preexisting business, even if the loss company's assets earn little or no income, and obtain twice the amount of carryovers than the sellers would realistically have ever used. Or, the buyer can go out and purchase other profitable assets with leverage, i.e., using debt secured by the acquired assets themselves, and also increase the total amount of allowed carryovers by using 10 percent of an enlarged pot. By enlarging the total pot of earnings as soon and as often as he can, the buyer can also use carryovers at a faster rate than the sellers would realistically have used them. Yet these are results that the Staff Report says it wants to prevent, namely, using acquired losses against income from capital over and above the capital used in the loss business (Staff Report, p. 100), and using carryovers to offset earnings attributable to "other, additional capital" (Staff Report, id.).

The problem largely lies in a "simplifying assumption" made by the Staff that some of the post-acquisition income of the combined company after a merger should be "deemed" to be allocable to the loss company's assets. The Staff Report concedes that this assumption may be "flawed." Staff Report, p. 102. Indeed, the assumption is flawed and the "flaw" is fatal to the entire concept. I predict that you will see losses used against unrelated income without any upper limit to a degree that will embarrass you and produce cases of abuse as well publicized as those involving safe harbor leasing.

Loss Year versus Carryover Year. The notion of computing allowable losses by comparing persons who owned the loss company in each old "loss year" and persons who were shareholders in each carryover year illustrates a complexity which will not accomplish what the Staff thinks it will accomplish. The Staff idea here is to trace the earning power of particular business assets owned by the company in each old year when it suffered an operating loss. The trouble is that the old assets will in most cases no longer exist and completely different assets will exist in the carryover years; comparing the two is comparing apples with oranges. There is also no good way to determine the earnings prospects of corporate assets in each old year (looking at the shareholders in those years will surely not do it). It is entirely sufficient to base a workable rule on the purchase price paid for the loss company's assets owned by it at the date of sale. That idea will in fact carry out more precisely the American Law Institute's own idea of viewing a merger as a "pooling" of both companies' assets and capital as of that discrete point in time.

Expiring Carryovers. As to the buyer's rate of use of carryovers, if you adopt a single purchase price rule, then, once we cut the carryovers "down to size," and limit them to the present value of the earnings prospects at the date of sale, we allow only carryovers that are incidental to a transfer of real economic values. We allow an amount of carryovers proportional to the earning prospects from the business assets. It is unnecessary overkill to go further and limit the buyer's rate of use of carryovers. Some have said that a flat purchase price rule would allow a buyer to use expiring carryovers which the seller would presumably not have been able to use. The same result can occur as I have said, with the Staff's proposal for merger transactions. But it seems to me there is little or no real problem here. With a 15 year carryover, a "real" financially troubled or insolvent company could not stay in business for ten or more years suffering losses or intermittent profits and survive long enough to have "expiring" carrovers. Some companies, however, may continuously generate artificial operating losses from ACRS deductions, such as tank car or other leasing companies, and might have expiring carryovers. These "cash rich" companies would probably not sell out voluntarily, but they might be subject to a hostile takeover. This is the universe of cases raising a problem and it is probably relatively small.

But once we limit the buyer, under a purchase price rule, to a total amount of carryovers keyed to the earnings prospects from the business assets he has acquired, we have dealt with the only aspects of the "loss trafficking" problem which are really important. If the buyer can make productive use of the seller's assets, I am not troubled by allowing the buyer to use a carryover that would have otherwise expired in one or two years and would probably not have been used by the sellers. Indeed, if a loss carryover were produced by accelerated deductions based solely on timing factors, we probably *want* a buyer to be able to use such a loss even if it was about to expire in the seller's hands.

Nonetheless, if an immediate deduction of even the present value of a reduced amount of carryovers is considered too great an immediate revenue loss for the Treasury, we could stretch out the buyer's use of the loss over four or five years, possibly with an interest factor added. Clearly, such a stretch-out, i.e., dividing the purchase price by four or five, would be far easier to compute and apply in practice than the task of applying a statutory table to actual income or deciding a rate of return and deciding how to vary that rate from year to year.

Treatment of Creditors

Creditors occupy a middle position between shareholders and complete outsiders with respect to a corporation. Their proper treatment under any new system of rules we might adopt deserves some special attention. It seems to me improper, too difficult, and unnecessary to try to segregate creditors, particularly where the loss company is insolvent, according to the year when each separate creditor advanced money. This is what the Staff proposal would do. If the loss company is insolvent or in bankruptcy, and the creditors agree to accept stock for part or all of their claims (in lieu of liquidating the company), one practical possibility is to look only to the creditors as a group who receive stock regardless of the year when their loans arose. If we adopt a uniform purchase price rule, the aggregate unpaid balance of the creditors' claims could be treated as their purchase price for the stock.[2]

Summary

I would stress these advantages:

-- A single purchase price rule is much simpler to understand and to apply to actual transactions than the convolutions and calculations of the ALI proposal. It would be a single rule for all types of payment made by a buyer, without complex two-part rules, imputed rates of return or statutory tables. It avoids special rules to deal with accelerated dividend preferences, inflated face amount notes with balloon payments at the end, and other types of "funny" instruments trying to maximize the rate of return formula.

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[2] In order to prevent abuses by persons who purchased debt claims in order to receive stock, this rule might be limited to creditors who extended credit directly to the debtor company. Or, the Service might be authorized to ignore stock issued to a creditor who acquired the claim for a purpose to acquire stock.

-- The purchase price rule would be entirely automatic and self-regulating, in ways the ALI rule would not. All rates of return and discount rates are automatically reflected in the purchase price which the parties themselves agree on. Congress need add little else.

-- A single, uniform purchase price rule comes closer to targeting the earning potential from the loss company's assets than the income percentage, or merger, rule would do. The merger rule, by contrast, would potentially allow a buyer to obtain more carryovers than the seller would realistically have obtained and more than the flat purchase price rule would allow.

Conclusion

Many of us who have studied the origins of the Staff proposal in the loss carryover area feel that a single uniform purchase price rule is easier to understand and to apply to real world transactions. It achieves the same basic objectives as the Staff proposal, without losing itself in secondary objectives which threaten to make the whole body of rules unadministrable. Every legitimate problem we are worried about can be solved more simply and equally effectively by the single rule.

This subject is the one part of the Staff Report which threatens not to simplify the corporate tax rules, but to take it to levels of intricacy which would baffle all of us and open the door to wider tax evasion. Based on the testimony of the Treasury, the American Bar Association and the New York Bar Tax Sections, and other witnesses at the recent House hearing on the same proposal, I respectfully suggest that a real consensus exists in favor of the simpler, easier to apply but equally effective purchase price rule.

Thank you.

TESTIMONY OF NICHOLAS A. TOMASULO

I am here, appearing on my own behalf, to urge this Committee and this Congress to stop throwing revenue away in an unfair and unproductive manner by permitting the transfer of losses of dead corporate businesses.

The basic construct of fairness is, of course, that one corporate taxpayer should not be permitted to deduct another corporate taxpayer's loss, just as no corporation should be compelled to pay another corporation's tax. Thus the basic issue is one of corporate identity.

Let's now take an example from an Article which I recently co-authored:[1]

> "The Fig family owned all the stock of a corporation which owned a brewery that lost money for many years. Losing hope that the business would recover, the company sold all its brewery assets and purchased a portfolio of stocks and bonds and a medium-sized apartment house. The Newton family then bought all the stock, intending to place a profitable construction business in the loss corporation. It is plain that the new owners are entirely different, the new business is different, and the new business assets are different under the Newtons. The only continuity lies in the corporate charter and in the possibility that the stock certificates are still printed on the same color paper." (Compare Alprosa Watch Corp.)[2]

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[1] Net Operating Loss Carryovers - The Search for Corporate Identity;" Bacon and Tomasulo; Tax Notes; Monday, September 12, 1983; Volume XX, Number 11, page 835 and page 847, column 1

[2] 11 TC 240 (1948.)

Now in what sense is the corporate taxpayer purchased by the Newton Family the same corporate taxpayer as the one which suffered the losses? Nothing whatever is the same as it was before except the color of the stock certificates. In every reasonable sense, so far as the losses are concerned, the corporation is a new tax entity using the old charter the way a Zombie uses the dead body of another person. It is really very hard to see how it can be considered just or fair to permit this corporate Zombie (so to speak) to use the losses of a different corporation whose body (or charter) it appropriated.

To say that the corporation still is a continuing "capital fund" is a word salad rather than an argument. Obviously, when an individual taxpayer dies, his estate is, in a sense, a continuing capital fund of his assets. Nevertheless, this does not make the estate the same taxpayer as the decedent for operating loss purposes. There is certainly no reason for the corporate rule to be any different.

But of course it is possible for a loss corporation to become an "incorporated pocketbook" only in part and retain some of its business assets. In such a case, the corporate identity must be viewed as surviving to the extent business assets are retained, and as dying to the extent business assets are converted to investments. As must be obvious, this requires that we adjust the purchase price (the base on which allowable losses are to be computed) by subtracting the Fair Market Value of the investment assets. The remainder of the price, after this subtraction, will, of course, be attributable to the business assets. Thus the loss allowable will be in some reasonable proportion to the business assets that the buyer wanted to acquire and did in fact acquire. The fact that investment assets were also acquired will in effect be disregarded.

One further step is necessary. To cover cases like Alprosa Watch Corp. (supra) in which the business assets are sold after the change in ownership, it must be provided that the purchase or acquisition price shall be further reduced by the amount realized on sales of business assets after the change in ownership.

It must be realized that the idea that a loss should be permitted to survive only in some reasonable proportion to the business assets is not really a fresh or new thought, but rather a concept which emerges naturally from consideration of the identity of a corporation which has operating losses from the operation of a business. Obviously, when all the stock is sold the character and identity of the corporation must be determined by the kind and amount of business assets it is engaged in exploiting. What other standard could there be?

Suppose all the stock of a loss corporation is sold for $600,000. At the time of the sale, the corporation owns only stock of General Motors worth $250,000 and all the business assets of a hardware store (which it operates) worth $260,000. Under our proposals the losses allowable would indirectly be measured by the value of the hardware assets -- which are assets used in the corporation's unique business and thus define the character, size and identity of the corporation as the taxpayer which incurred the loss. On the other hand, the General Motors stock isjust like any other General Motors stock. It is not unique in any sense and tells us absolutely nothing about the history of the corporation. Thus losses measured by the value of the General Motors stock are "Zombie" losses. To allow such losses is a gross and very silly injustice. It is moreover a waste of revenues on a random and wholly unreasonable basis.

To illustrate the mechanics of the basic suggestion, an appendix consisting of a simple table is attached.

I welcome an opportunity to answer questions.

APPENDIX

Table to Illustrate Mechanics of Basic Suggestion

Base for Computing Amount Allowable of Presale (Old) Losses:

Grossed Up Price:

Amount which would have been paid for 100 percent of the stock of the loss corporation at unit price actually paid		________
Deduction: Loss Corporation's:		
(a) Cash, and cash equivalents	________	
(b) Nonbusiness assets (investments)	________	
(c) Business assets acquired within two years of sale, *except* those for use in a business in which the loss corporation was engaged before the time of the purchase of such assets	________	
Total Deductions	________	
Total Deductions (subtract)		________
Base (Grossed up price minus deductions)		________
Special Post-Sale Deduction:		
Amounts realized on the sales of business assets of the loss corporation within five years of the sale of the stock	________	
Base, as above adjusted		________

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STATEMENT OF JAMES ROCHE, ESQ., McDERMOTT, WILL & EMERY, CHICAGO, ILL.

Mr. **Roche**. Mr. Chairman, my name is James Roche. I'm a tax lawyer from Chicago.

One of my principal concerns at the beginning of this hearing was the matter of whether additional time would be taken to consider these proposals. They are very important, have significant impact and I am very pleased to see that the committee is planning to proceed in that fashion.

I think despite the thorough way in which the staff approached these matters there are still a lot of tax practitioners out there who are not very familiar with these proposals, and they should be heard from.

Our substantive points, I think, really boil down to two at this stage. One has to do with the repeal of the General Utilities rule. We feel that Mr. Nolan makes an excellent point when he discusses that in connection with the sale of businesses. However, the proposal to provide a tax credit is one that we think is unworkable under those circumstances. There would be questions that would arise as to how that tax credit would be allocated. For example, how would you distinguish between preferred stockholders, common stockholders, convertible debt holders, and the like?

We think questions would arise as to whether a credit should be carried forward or carried backward in a particular year if for other reasons the shareholder was unable to use it. What would happen if there was a subsequent adjustment in the taxable income of the corporation, either increasing or reducing the tax? Would you then have to go back and adjust the credits that might have been claimed by many, many stockholders?

Finally, we think that it does not address the problem that would exist with respect to exempt organizations since it would, in effect, be imposing a tax on them where none exists at the present time.

In connection with liquidating distributions, again, we have some difficulty with the proposal. It would impose the tax at a corporate level when the corporation may be distributing essentially illiquid assets. We think that carryover basis might be a better alternative to that problem.

In addition, under present law there is a significant shareholder tax that is imposed on such a distribution. I'm not sure that that's not adequate to deal with the problem in any event.

Finally, even in connection with ordinary distributions we would question the wisdom of repealing the General Utilities rule. The imposition of taxes up to 73 percent is a pretty steep measure. Under present law if these ordinary income assets are distributed, they generate dividend income in most cases, and you are talking about taxes at rates of up to 50 percent. Shareholders don't undertake that kind of taxation lightly.

Finally, in the area of earnings and profits, I agree with Mr. Alexander. I think the system has worked pretty well. It ought to be fixed and not discarded. Unfortunately, none of our systems work perfectly. But, again, we are dealing in areas where the tax rates may go up to 73 percent, and I think we should be equally as concerned about not extending those rates to new areas as we are in trying to ferret out the few instances where they may be partially avoided.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. James Roche follows:]

STATEMENT OF JAMES M. ROCHE

COMMENTS ON SENATE FINANCE COMMITTEE

CORPORATE INCOME TAX PROPOSALS

James M. Roche - Partner, McDermott, Will & Emery
Chicago, Washington, D.C., Miami, Boston, Springfield (IL)

The Subchapter C proposal set forth by the Senate Finance Committee Staff would, if enacted into law, result in major changes in the federal income tax treatment of corporate acquisitions and distributions. The proposals would replace a statutory scheme involving corporate acquisitions, distributions and liquidations which, with certain modifications, has existed for over 30 years. The proposals would require taxpayers and their advisors to familiarize themselves with an entirely new system of corporate taxation.

A. Need for More Thorough Consideration.

Given the sweeping nature of the proposals, we would strongly urge that more thorough and deliberate consideration beyond 1 day of hearings be given to the changes suggested by the staff. The period of time between the release of the staff report (September 26) and the scheduled hearing date (October 24) has been 4 weeks. It is simply impossible for the tax bar, professional accounting organizations and interested taxpayers to fully digest the impact of these proposed changes during such a short period of time. While certain groups have had some exposure to these proposals, most tax practitioners have only recently had an opportunity to examine them. The danger in moving too quickly in this area is that the proposed legislation may contain unanticipated pitfalls. Moreover, the proposed legislation may conflict with other stated Congressional objectives, such as capital formation.

In recent years, Congress has had the opportunity to consider tax simplification measures which have generally benefited taxpayers. The Installment Sales Act of 1980 and the Subchapter S Revision Act of 1982 are two examples of carefully conceived tax legislation which greatly simplified complex areas of the tax law. Both pieces of tax legislation were enacted after several years of input from the organized tax bar and interested taxpayers. The legislation which resulted from this type of cooperative effort has been of very high quality.

In contrast, the Tax Equity and Fiscal Responsibility Act of 1982 was enacted after less than three months of Congressional deliberation. As a result, these provisions have been criticized (even in the staff study) as overly complex and inappropriate in certain respects. For example, the complexities associated with section 338 have made it difficult for even sophisticated tax advisors to properly counsel their clients with respect to corporate acquisitions. While section 338 may be an extreme example, history has shown that hastily enacted tax legislation results in unforseen problems.

In summary, we believe that Congress should give careful consideration to the staff proposals. This consideration should result in a comprehensive hearing process so that all interested parties can fully and fairly comment on the staff proposals. A robust examination of Subchapter C will most likely lead to an equitable simplification of an admittedly complex portion of the Internal Revenue Code.

B. Reliance Upon Existing Code Provisions.

Subchapter C, as the staff report properly noted, has not been examined by the Congress in at least 30 years. This has resulted in substantial reliance by corporate taxpayers upon the existing provisions of Subchpater C in structuring ongoing business transactions. Thus, corporations relying upon Subchapter C in developing capital structures may be forced to change direction in midstream. For example, corporations which have been able to continuously raise capital at attractive prices due to the current rules regarding earnings and profits may find it more difficult to do so if the staff proposal is adopted. Moreover, owners of medium sized corporations who have been contemplating the disposition of their business (through a tax-free reorganization, stock sale or section 337 liquidation) may be forced to make sudden decisions based upon a comparison of current Subchapter C and the proposals set forth in the staff report.

Due to the continuing reliance upon existing Subchapter C by taxpayers and their advisors, we believe serious consideration should be given to making the effective date of the proposed legislation at least one year after the date of final enactment. Notwithstanding the "binding contract" language in the staff report, we can perceive several instances in which taxpayers who are presently involved in a corporate transaction might find the rules changed in the middle of a transaction.

Recommendation: In order to provide an orderly conclusion of pending business activities, any changes in Subchapter C should be made effective only after the expiration of a substantial period of time.

C. Repeal of General Utilities Doctrine Should be Modified.

1. More Equitable Treatment of Distributions.

The most significant impact of the staff proposal is the repeal of the doctrine enunciated in General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). This doctrine, as set forth in sections 311 and 336, allows a corporation to distribute, as a dividend or in complete liquidation, appreciated property without the imposition of a tax at the corporate level, with the exception of recapture items and LIFO inventory. Section 337 further provides that a corporation which sells assets within a 12 month period commencing on the date a plan of liquidation is adopted shall not recognize any gain or loss (except for recapture items and LIFO inventory) upon such sales. Section 337 compliments section

336 in that any Court Holding Company issue as to whether the liquidating corporation or its shareholders "sell" corporate assets is irrelevant.

The staff has proposed the complete repeal of the General Utilities doctrine. While the repeal of General Utilities would seem to simplify the Code and would permit the rules relating to collapsible corporations to be eliminated, the economic impact of the proposal is to impose a heavier tax burden upon subchapter C corporations and their shareholders than upon partners in a partnership. If a corporation is taxed upon the distribution of an appreciated asset and the recepient is taxed upon receipt of such property, the transaction will be subject to tax at the corporate and shareholder level. In contrast, the distribution of the same asset by a partnership to a partner does not presently result in the recognition of income to the recipient partner or the distributing partnership. Moreover, the distribution of an appreciated asset by an S corporation results in the imposition of only a shareholder level tax.

We believe that the Internal Revenue Code should not be amended in such a manner whereby small to medium sized businesses are forced to operate as partnerships rather than corporations. Most business enterprises are conducted as corporations in order to alleviate owner concerns involving limited liability. If the staff proposal is enacted into law, businessmen will be forced to make tax, rather than business, motivated decisions as to the conduct of their activities through a corporation or partnership.

Many small and medium sized enterprises may operate as partnerships if the staff proposal is enacted since operating as a partnership would result in an easier realignment of business assets. The distribution of an appreciated asset by a partnership will not lead to taxation of the partnership or partner. On the other hand, the same distribution made by a corporation would be taxed under the staff proposal rates of 42.4 to 73 percent.

The discrimination under the Code against regular corporations as business entities as opposed to partnerships cannot be justified. As a practical matter, most large scale businesses cannot be operated as partnerships. Moreover, while Subchapter S may be a viable alternative for some corporations, S status is not possible in many circumstances. A corporation which has preferred stock outstanding or owns a subsidiary is ineligible to make an S election. In addition, stock in family corporations is often held in trusts for valid estate planning reasons. Thus, the net result of the staff proposal is to introduce a new tax upon business entities which cannot be operated as partnerships or S corporations.

An argument can be made for the repeal of General Utilities with respect to the distribution of assets which would generate ordinary income at the corporate level, such as inventory.

However, the staff's proposal appears to have much less merit when applied to the distribution of appreciated historic assets. The current trend in the area of taxation, as evidenced by a reduction in the capital gains tax and the enactment of the Accelerated Cost Recovery System, is to enhance capital formation. While the staff report properly acknowledges that the sale of inventory and distribution of the after-tax proceeds could be taxed at a rate of up to 73 percent, it fails to recognize that the distribution of a capital asset might be taxed at a rate of up to 64 percent (in the case of a dividend distribution) or 42.4 percent (in the case of a liquidating distribution). This high rate of taxation on capital gains is totally inconsistent with the current stated Congressional policy of encouraging capital formation.

The foregoing discussion is not merely an academic exercise as to the merits of the General Utilities doctrine. We have been counsel to several medium sized corporations who have been forced to dispose of unwanted capital assets in a non-liquidation setting. There may be various reasons for the disposition of such assets by the corporation. For example, the corporation may be forced to dispose of business assets under pressure from regulatory authorities or lenders. In addition, a corporation may be forced to dispose of assets by virtue of high property taxation. If the shareholders of the corporation could put the unwanted assets to productive use and section 355 does not apply to the situation, present law provides for only a shareholder level tax upon the distribution of capital assets. We seriously question the wisdom of imposing a double tax upon the rearrangement of business assets among related taxpayers.

Recommendation: The distribution of an appreciated historic asset as a dividend should not lead to a corporate level tax except to the extent of any recapture items. The imposition of a corporate and shareholder tax upon a single transaction will result in confiscatory taxation upon transfer of appreciated assets. The policy behind such a rule is unclear, especially since existing law requires the recognition of dividend income upon the receipt of an appreciated asset by an individual shareholder based upon the fair market value of the asset distributed. Thus, under current law the receipt of appreciated property is subject to a tax of up to 50 percent. Moreover, the distributing corporation recognizes income to the extent of any depreciation, investment credit or LIFO recapture. We believe that the retention of *General Utilities* with respect to historic assets will permit the realignment of business assets at a reasonable tax cost. At the same time, the elimination of *General Utilities* with respect to inventory assets will eliminate most of the abuses currently associated with section 311.

Since the staff appears concerned with the repeal of the *General Utilities* doctrine as a means of stopping the "churning" of assets, we feel that the proper approach is to tighten the anti-churning rules under ACRS. Under existing law, a shareholder holding more than a 10 percent of the stock of a corporation is not entitled to ACRS if the corporation distributes an asset which it held before January 1, 1981. As a result, the anti-churning rules effectively limit the use of liquidation-reincorporation type transactions in situations involving pre-1981 assets. If the staff is concerned about anti-churning with respect to assets acquired by a corporation after 1980, the approach should be to extend anti-churning rules to all related party transactions. This approach would be more equitable than the blanket repeal of the General Utilities doctrine since only unrelated parties would be entitled to ACRS with respect to sales or distributions of depreciable assets. The extension of the anti-churning rules would appear to eliminate so-called tax motivated liquidations.

2. Sales of Businesses and Double Tax.

The repeal of the General Utilities doctrine in connection with the liquidation of a corporation will cause additional hardship to owners of small to medium sized corporations who wish to sell their businesses to unrelated parties. It has been our experience that the liquidation of a corporation is not a tax motivated transaction and results from a desire of the shareholders to terminate their involvement in the business. While the liquidation-reincorporation issue is a serious one, existing law is adequate to deal with it and we do not believe such concerns should result in the elimination of Code sections 336, 337 and 338. The elimination of these Code sections will result in a drastic increase in the tax burden associated with the sale of corporate assets or stock. The following example is indicative of a typical situation involving the sale of a corporate enterprise and indicates the increased taxes associated with the staff proposal.

Widgets, Inc. is a closely held manufacturing concern located in the Midwest and has been in business for over 40 years. The stock of Widgets, Inc. is held by 10 individuals who are either actively involved in the business or related to the company founder. The adjusted basis of Widgets, Inc. stock in the hands of the shareholders is $200,000. The adjusted basis of Widgets, Inc.'s assets is $2,000,000. The fair market value of Widgets, Inc.'s assets (including $750,000 in recapture items) is $5,000,000.

Under current law, if Widgets, Inc. sells its assets to Acquiring Corp. pursuant to a section 337 plan of liquidation, Widgets, Inc. will recognize only $750,000 of ordinary income with respect to the sale of its assets. The shareholders will be taxed at a 20 percent capital gains rate upon the receipt of a $4,625,000 liquidating distribution ($5,000,000 less $375,000 recapture tax) from the corporation. The shareholders will pay a capital gains tax of 20 percent of $4,425,000 or $885,000. The total tax burden with respect to the sale and liquidation equals 25.2 percent of the $5,000,000 gross sales proceeds.

Under the staff proposal, if Widgets, Inc. sells its assets to Acquiring Corp. and a cost basis election is made, Widget Corp. will recognize full gain or loss upon the asset sale. Widgets, Inc. will recognize $750,000 of ordinary income and $2,250,000 in capital gain income with respect to the sale. As a result, Widgets, Inc. will pay $1,005,000 in federal income taxes. Moreover, the shareholder will be taxed at a 20 percent capital gain rate upon the receipt of a $3,995,000 liquidating distribution ($5,000,000 less $1,005,000 taxes) from the corporation. The shareholders will pay a capital gains tax of 20 percent of $3,795,000 or $759,000. Under the staff proposal, the total tax burden with respect to the sale and liquidation equals 35.3 percent of the $5,000,000 gross sales proceeds.

* * *

This typical example illustrates the dramatic increase in taxes paid by owners who sell their corporate business. The individual who purchases and sells stock on an established securities market will pay a capital gains tax of no more than 20 percent. Yet the entrepreneur who devotes his energies and capital to his business can be taxed at a rate of up to 42.4 percent if the Staff proposal is adopted. This increased tax burden will reduce the incentive of small businessmen to risk capital, especially in circumstances where an S election is not feasible. In addition, owners will have an incentive to hold onto stock until death since the basis step-up at death will result in the reduction of the total tax burden associated with the disposition of the business. It would seem that a rational tax policy should encourage business owners to sell their enterprises during their lifetime and at a tax rate which is no greater than that paid by stock market investors.

Recommendation: In order to alleviate this problem, section 337 and 338 type protection should be retained upon the actual or deemed sale of historic assets. This rule would require target corporation to recognize gain upon the sale of current assets (i.e., inventory) while allowing the sale of historic business assets to escape double taxation. The entrepreneur would be able to sell his business at a tax effective rate and many General Utilities type abuses would be eliminated.

3. Difficulty of Providing a Shareholder Credit.

The Staff proposal suggested that one mechanism of avoiding a double tax upon a liquidating sale by a corporation is to provide a credit to a shareholder against his capital gain tax for his proportionate share of the liquidating corporation's capital-gain tax. The effectiveness of the credit at the shareholder level depends upon several variables, including the adjusted basis of liquidating corporation stock in the hands of a shareholder entitled to the credit.

We believe that the shareholder credit mechanism is an overly complex approach of alleviating problems associated with the repeal of General Utilities. Unlike the deemed foreign tax credit, where the shareholder obtaining the benefit of the credit must be a corporation which owns 10 percent or more of the stock of the foreign corporation, the liquidating credit would have to be made available to all shareholders. The following issues are indicative of the problems inherent with the shareholder credit approach.

a. How is the to be credit allocated among the various shareholders?

b. How are preferred shareholders and holders of convertible securities to be treated for purposes of computing their allocable share of the credit?

c. Can the credit be carried back and forward in instances where the shareholder has a net operating loss in the year of liquidation?

d. What adjustment is made to the credit in the event an audit of the corporation results in the underpayment or overpayment of capital gains tax paid by the liquidating corporation?

e. Will the credit be refundable if the shareholder is a pension fund or tax-exempt organization?

Recommendation: The use of a shareholder credit mechanism is not an acceptable means of alleviating problems associated with the repeal of General Utilities. The approach is overly complex and could result in substantial inequities. We believe the historic asset proposal set forth earlier in our testimony will be simpler to administer and will promote fair tax policy.

E. Repeal of Earnings and Profits.

The concept of earnings and profits as a measuring point in determining whether an ordinary distribution is taxable as a dividend has a long history. The policy behind an earnings and profits limitation is that a shareholder should not be taxed upon the receipt of an ordinary corporate distribution if the distribution is in the nature of a return of capital. A distribution has always been deemed to be a return of capital if the corporation has not realized economic income.

We believe that the historic development of the concept of earnings and profits continues to have current relevance. While the computation of earnings and profits involves the compilation of accounting data from the date of incorporation, it should be noted that the burden is always upon the taxpayer to prove that a distribution is not out of earnings and profits. One problem associated with earnings and profits are due to the fact that taxpayer recordkeeping is inadequate. However, the maintenance of adequate records has always been expected of taxpayers. Thus, the concept of earnings and profits should not be eliminated merely due to recordkeeping problems. It should be noted that the Staff proposals would continue the computation of earnings and profits for certain purposes.

The other problem associated with earnings and profits involves the method of computing earnings and profits. In general, the concept of earnings and profits is not defined by the Internal Revenue Code. While taxable income is the starting point in computing earnings and profits, additional adjustments are made to conform earnings and profits with economic income. Further adjustments are made to prevent corporations from using certain accounting techniques such as accelerated depreciation from artifically depressing earnings and profits.

The abuses mentioned by the staff in the earnings and profits area involve accounting issues. In particular, the use of deep discount obligations and the completed contract method of accounting are seen by the staff as mechanisms whereby earnings and profits are understated. We agree with the Staff's concern and would strongly support any legislation which would modify these loopholes. Moreover, we believe that the staff should be directing all of its efforts in the earnings and profits area toward developing a comprehensive set of accounting rules governing the computation of earnings and profits.

Recommendation: We believe in the retention of the present rule which provides that only those distributions out of current or accumulated earnings and profits are taxable as ordinary income to the recipient shareholder. Furthermore, we believe that the staff should close accounting loopholes (such as the distribution of deep discount obligations and the use of the completed contract method) which result in the manipulation of earnings and profits. In our view, the soundest result can be achieved by the development of a comprehensive definition of earnings and profits.

F. Acquisition and Mergers Proposal

We generally agree with the Staff's proposal relating to the tax treatment of coporate acquisitions. We support the notion that "A", "B", "C" and triangular reorganizations will be treated under similar rules. The ability of an acquiring corporation to treat an asset or stock acquisition as either a cost or carryover basis transaction should provide for maximum business flexibility. In addition, the independent tax treatment of shareholders, depending solely upon whether a shareholder receives stock or cash, will prevent inequitable results.

While we generally support the staff's corporate acquisition suggestions, we believe that the proposals should be conformed to our recommendation that limited section 337 and 338 type protection be given to qualified stock and asset acquisitions. In particular, when acquiring corporation makes a cost basis election with respect to a qualified stock or asset acquisition, the gain recognized by target corporation should be limited to the disposition of non-historic assets plus recapture items. This type of tax structure will result in the recognition of "tainted" income at the corporate level while also eliminating the problem of complete double taxation.

G. Loss of Basis in Carryover Basis Acquisition

Under the staff proposal, the basis of subsidiary stock held by a parent corporation would always equal the net adjusted basis of a controlled subsidiary's assets. This rule would apply even in instances where an affiliated group does not file consolidated returns. As a result, if an acquiring corporation makes a carryover basis election with respect to a qualified stock acquisition and the fair market value of the consideration received by former target shareholders exceeds the inside basis of target assets, acquiring corporation will permanently lose basis in target stock. If acquiring corporation subsequently sells target stock, it would be required to pay tax, in part, on a return of capital.

We strongly oppose the staff proposal which would equalize the inside and outside basis of target corporation stock and assets. The proposal represents a significant departure from the notion that a corporation and its shareholder are two separate taxpayers. Under present law, shareholders in a corporation (other than an S corporation) do not receive a basis step-up upon the reinvestment of corporate earnings. The reason is simple: The shareholder should not obtain a basis step-up unless a corresponding amount of taxable income is recognized by the taxpayer.

We do not believe that an acquiring corporation should be further penalized for making a carryover basis election. If target assets have a basis of less than the consideration received by former target shareholders, acquiring corporation already would be at a disadvantage since there is no basis step-up in target assets. The loss of the purchase premium as a component of stock basis would create even greater hardship. While the separation of inside and outside basis may cause different tax results arising from an asset sale as opposed to a stock sale by members of an affiliated group, this type of problem is presently faced by individuals who sell corporate stock. We feel that pre-affiliation inside basis should not affect the outside basis of target stock regardless of whether the owner is an individual or corporation.

Due to the fact that the staff proposal would equalize inside and outside basis only in situations where acquiring and target corporations are members of the same affiliated group, it would be relatively easy to avoid this rule in situations where acquiring corporation is closely held. For example, shareholders of acquiring corporation could purchase 21 percent of target stock while the remaining 79 percent stock interest could be purchased by acquiring corporation. Alternatively, shareholders of acquiring corporation could establish a sister corporation to purchase over 20 percent of target stock. Since neither of these transactions constitute a qualified stock acquisition, there is no loss of basis of target stock in the hands of the shareholders.

Recommendation: We favor the retention of present rules pertaining to inside and outside basis of target stock and assets. If the staff feels that failure to make postaffiliation adjustments leads to inequitable results, we would suggest that these issues should be considered separately either through legislation or the amendment of the consolidated return regulations.

H. Liquidations as Carryover Basis Transactions.

Under the staff proposal, all liquidations (except liquidations qualifying under section 332 and liquidations associated with carryover basis qualified asset acquisitions) will be cost basis transactions. Thus, section 333 will be repealed. As a result, a cost basis liquidation will result in gain at both the corporate and shareholder level. Many liquidating corporations may have primarily non-cash assets to distribute to shareholders and may not be in a position to pay income tax.

The characterization of a liquidation as a cost basis transaction may result in the distress sale of valuable business assets in order to pay federal income tax. The tax law should not require the recognition of income upon the transfer of assets where there is direct or indirect continuity of interest in the possession of an asset.

We believe that a taxpayer should be entitled to elect treatment of a liquidation as a carryover basis transaction in a manner similar to an incorporation. In both instances, assets are being transferred to and from related entities. Taxpayers should be allowed to make such transfers without being concerned about tax considerations.

Recommendation: In the case of a liquidation, a shareholder should be entitled to elect to take a basis in distributed assets equal to the adjusted basis of stock surrendered. The shareholder would not be required to recognize gain or loss except to the extent of cash received. The distributing corporation should not be required to recognize any gain or loss (including recapture income) upon a carryover basis liquidation except, perhaps, with respect to inventory. There is little room for tax abuse under this proposal since any earnings and profits earned by the liquidating corporation "disappear" and are not reflected in the adjusted basis of assets held by the shareholders.

Although our proposal modifies section 333 in that the earnings and profits are not deemed distributed in connection with the liquidation, we believe carryover basis liquidations should be encouraged. In order to prevent abusive transactions, our proposal could be limited to non-corporate shareholders who have held stock in the liquidating corporation for a specified period of time. For example, the time period could be the lesser of 5 years or the length of time the corporation has been in existence.

Our proposal is designed to place a carryover basis liquidation exactly on par with an incorporation. Since the adjusted basis of assets received by the transferee in both cases is equal to the basis of assets transferred, there is no basis step-up. Therefore, our proposal equates nonrecognition of gain with carryover basis and is consistent with the approach taken by staff in the reorganization proposals.

* * *

The above recommendations touch only a few of the Staff proposals. There are important issues raised in connection with some of the other proposals which are not practical for us to discuss here. They can be considered only if the Committee provides additional time so that other interested parties can formulate their views and present them for analysis. This will produce a much better result for the Government and taxpayers alike.

The CHAIRMAN. I will assure this panel that we are reviewing the report. We wanted to hear a wide range of witnesses and we have done that. And I know there are probably a lot of questions you could answer, but I wouldn't know how to ask them. I would ask one question of Mr. Nad though.

Your written testimony urges that no changes should be made to the dividends received deduction. As a result, as I have indicated earlier, corporations would be entitled to claim short-term losses deductible at 46 percent rate while paying only a 6.9 percent tax on the income.

I'm told—it may be incorrect—that we will lose about $43 million in the payment of the Chrysler dividend alone. Now why isn't that something we ought to change? How can you justify that?

Mr. NAD. Well, I think as long as you have multiple taxation factors involved, that is justified. If you would like to find a solution to the multiple tax layers, I think maybe I could agree to that.

The CHAIRMAN. There may not be multiple taxation, of course. Have you got a solution in that case?

Mr. NAD. No. I do think perhaps shareholder credits or deductions or corporate dividends might be the way. But it doesn't seem to me that you are focusing on some of the major problems. Even the report says that; $43 million is a considerable amount of money, but think perhaps that problem is vasty exaggerated.

The **Chairman**. It may be, but I think it's the kind of thing that interests people around here. We are always looking for money to spend. And some of that money we can save. And if we are just going to dish out $43 million, well——

Mr. **Nad**. Tax practitioners have difficulty with solving your budget problems. They can only tell you the technical points, as you know. We are very modest in that regard.

The **Chairman**. I think that if this panel is willing we might, after we have had a chance to go through your statements—if you would be willing to submit to some questions in writing if we have questions in writing.

Again, I am in the learning process. I haven't spent 12 months on it as the staff has. We appreciate very much your willingness to come and testify. We can assure Mr. Roche that we are going to try to move the project. We are not going to try to steamroller anyone in the process. There will be opportunities for all the practitioners to have an input.

Thank you very much.

Our next panel is Mr. Gallatin, managing director, Lehman Bros.; Robert Flaherty; Warren Jobe; and Scott Johnson.

STATEMENT OF RONALD L. GALLATIN, MANAGING DIRECTOR, LEHMAN BROS. KUHN LOEB, INC., NEW YORK, N.Y.

Mr. **Gallatin**. Senator, my name is Ronald Gallatin. I'm a managing director of Lehman Bros. Kuhn Loeb, Inc., and a member of the capital formation and tax policy committee of the Securities Industry Association.

Other speakers, orally and in writing, have discussed the tax policy implications of the proposed changes in the dividends received deduction, and, in particular, the fact that the staff's proposals would increase the tax law's present heavy bias in favor of debt over equity financing.

I would like to address today the disastrous impact which these proposals will have on our Nation's capital markets.

First, the immediate impact of the proposals could be an overnight decline of $5 to $10 billion in the market value of currently outstanding preferred stocks, as well as a dramatic decline in the much larger market of high dividend common stocks; particularly, those issued by utilities.

Second, in the long run these proposals would result in a permanent reduction in market liquidity and such a large increase in the required dividend yield of these stocks that many potential issuers will be forced to borrow rather than sell equity. Some issuers will be completely frozen out of the capital markets. The inevitable result will be excessively leveraged balance sheets, stagnation of growth, and in some cases even bankruptcy.

The impact of these proposals is already being felt. By last Friday, the market for preferred stocks had come to a virtual stand still. A call to my office around noon today indicated that that was still the case.

Major holders of preferred stocks were considering disposition of their portfolios and investment bankers could not advise issuers to bring new issues to the market.

Accordingly, we believe that it is absolutely imperative that the committee immediately announce that it will not sponsor any legislation that will not be truly prospective. I would analogize this to your comment earlier, Senator, that with reference to publicly traded limited partnerships you were talking only about newly formed limited partnerships.

Lehman Bros. believes that any legislative changes should, at most, involve a modest change in the holding period requirement for preferred stocks. And both Lehman Bros. and the Securities Industry Association are prepared to work with the committee in the formulation of appropriate legislation.

Thank you, Senator.

The CHAIRMAN. Thank you.

[The prepared statement of Ronald L. Gallatin follows:]

STATEMENT OF RONALD L. GALLATIN
Managing Director, Lehman Brothers Kuhn Loeb Incorporated

Proposed Limitations On the Dividends Received Deduction
Presented In The Staff Report
"The Reform And Simplification Of The Income Taxation Of Corporations"
September 22, 1983

Committee on Finance
United States Senate
October 24, 1983

Mr. Chairman and Members of the Committee, I appreciate this opportunity to present the views of Lehman Brothers Kuhn Loeb Incorporated concerning the changes in the taxation of intercorporate dividends proposed in the Staff Report.[1] Our firm believes that these proposals are seriously flawed, and that if enacted as proposed, they would threaten major disruptions in the nation's capital markets. At the same time, we would like to offer some suggestions as to how the objectives sought by these proposals could be achieved consistent with generally accepted principles of sound tax and economic policy.

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[1] "The Reform and Simplification Of The Income Taxation Of Corporations," A Preliminary Report Prepared By The Staff of the Committee on Finance, United States Senate, S. Prt. 98-95 (1983) (hereinafter referred to as "Staff Report").

Summary of Proposals

The items which concern us are: first, denial of the 85 percent dividends received deduction for dividends received on stock held for less than one year; second, disallowance of a deduction for 85 percent of the interest expense incurred to purchase or carry stock which generates dividends eligible for the dividends received deduction; and third, the proposal to make these changes effective on January 1, 1984 with respect to presently outstanding as well as newly issued stock.

As written, the proposals would have a serious adverse impact on all legitimate participants in the capital markets -- issuers, corporate investors, underwriters and market makers. In particular, we respectfully submit that:

> The first two proposals would significantly increase the financing costs to issuers of preferred stocks and high-dividend common stocks, and could well impair the ability of such issuers to raise capital at all; and
>
> The proposal to make the changes effective for stock acquired and interest accruing after December 31, 1983 -- even with respect to previously outstanding issues -- would result in a major shock to the capital markets by instantaneously reducing the market value of all such preferred and high-dividend common stocks.

The Proposals Would Result in Major Disruptions of the Nation's Capital Markets

If enacted as proposed, the two substantive changes proposed in the Staff Report would result in economic losses and dislocations grossly in excess of any possible revenue gains or other benefits for the tax system. In general, the impact of the changes would be felt most accutely in the market for stocks whose price depends principally on their dividend yield, particularly non-convertible preferred stocks. The market for adjustable rate preferred stock -- a market which has grown to $6.5 billion and is just now beginning to be a dependable source of financing -- would be the most severely affected. Each of the proposed changes would make these stocks significantly less attractive to corporate investors, who are the dominant purchasers in this market.

Holding Period. If a significantly longer holding period is required in order to qualify for the dividends received deduction, the value of the deduction would be reduced dramatically for taxpaying corporations seeking liquid investments for funds that must be readily available to meet ongoing business needs. Such investors do not anticipate holding financial assets for a year and will require a higher dividend yield to accept such a holding period. As a consequence, investors that are now willing to purchase stocks at a yield that reflects the value of the dividends received deduction (resulting in lower actual cost to issuers) would seek other investments.

Interest Deduction. The impact of the proposal to deny the interest paid deduction for debt used to purchase or carry stock is potentially even more serious. The critical point which appears from the Staff Report is that the interest deduction disallowance is intended to be applied on a purely mechanical basis, without regard to whether there is any traceable connection between a particular debt and the acquisition of any particular shares of stock. Such a rule would effectively deny a deduction for a part of the interest expense incurred by virtually every corporation which owns any common or preferred stock now outstanding. This proposal would affect every decision to acquire stock, underwrite stock or make a market in stock.

Impact on Current Holders

The Staff Report indicates that the proposals are to be made effective for "stock acquired, interest accruing . . . after December 31, 1983."[2] Such an effective date would cause the proposals to apply to all outstanding common and preferred stock as well as to stock issued in the future. It would dramatically reduce the value of all high-dividend stocks now outstanding because all prospective purchasers would be subject to the new rules even though the stock was issued and originally acquired prior to the nominal effective date. In our judgment, such a *de facto* retroactive effect would result in many billions of dollars of loss in market value among currently outstanding adjustable and fixed-rate preferred stocks, not to mention the effect on the larger market of high-dividend common stocks.

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[2] Staff Report, *supra*, at p. 79.

Another aspect of this timing problem is equally serious. The erosion in value which we foresee will begin even before the proposals are enacted, once there is a perception among the major participants in the market that enactment is a realistic possibility. The only way to avert this loss is for the Committee to announce as soon as possible that *any* changes which are adopted in the taxation of intercorporate dividends will be made applicable only prospectively — that is, only to stock *issued* after a fixed future date.

Impact on Issuers

Although current holders of high-dividend stocks will suffer an immediate loss from the proposed changes, the more serious and lasting consequences will affect those corporations which in the normal course of business would be issuers of such securities. This burden upon issuers could have extreme negative effects in the form of increased financing cost and constriction of the capital markets. In addition, as the Staff Report recognizes, the present tax treatment of intercorporate dividends already reflects a "general bias in favor of debt."[3] The proposed changes would increase this bias, and thereby tend to further encourage a highly leveraged capital structure which impairs the ability of corporations to withstand adverse economic developments and increases the possibility of bankruptcy.

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[3] Staff Report, *supra*, at p. 48.

The most dramatic impact of the proposed changes would be felt by the issuers of adjustable rate preferred stocks. The explanation for this focal point is quite simple: short-term corporate investors represent the single largest purchasers of adjustable rate preferred stocks, and the proposed changes will affect the investment preferences of such investors more than those of any other group.

The costs of raising equity capital through fixed rate preferred stock and high-dividend common stock (which is issued primarily by utilities) would also increase as a result of the proposed changes. The increase would not be as dramatic as in the case of adjustable rate preferred stocks, because short-term corporate investors are a smaller percentage of the investors in these instruments. However, in the case of fixed rate preferred stocks, even small reductions in demand cause significant increases in yields because the market for such stocks is already extremely illiquid. For high-dividend common stocks, liquidity would also be reduced.

Less demand from short-term corporate investors will constrict (or eliminate) the market for adjustable rate preferred stocks, which in turn will cause issuers to attempt to tap the markets for fixed rate preferred or high dividend common -- at a time when the same reduced demand from short-term corporate investors is already causing the costs of issuing those types of securities to increase. Undoubtedly, some issuers will be unable to issue stock at all.

The perverse impact of the proposed changes is clearly revealed by a consideration of the specific industry groups which will be most adversely affected:

> Banks must obtain equity capital in order to meet minimum capital requirements imposed by federal and state regulatory authorities. Adjustable and fixed rate preferred stocks generally represent banks' least expensive sources of primary capital. Higher costs of capital could erode the capital base of the banking industry.
>
> Utilities have a constant need to raise equity capital in proportion to their ever-increasing debt obligations in order to finance the expansion required to meet their customers' increasing demand for service. High-dividend common and preferred stocks are utility companies' only sources of equity and any increase in these equity costs will eventually become an additional burden for ratepayers. In addition, utilities in the past have been concerned about being unable to raise capital at any cost. Any constrictions in the equity markets, such as would be caused by these proposals, are certain to exacerbate these fears.

For these industries, in particular, the proposed changes threaten stagnation in growth resulting from an inability to raise capital for expansion. It is, of course, especially ironic that the damage will occur in just those fields for which the maintenance of a strong capital base serves important public as well as private interests.

The Objectives of The Proposals Can Be Achieved Through Alternative Methods Which Are Consistent With Both Tax and Economic Policy

The proposed changes in the taxation of intercorporate dividends would entail far greater economic costs than the revenue lost from any purported abuses of the present system. This results from the fact that the proposals would affect virtually every holder and every issuer of preferred and high-dividend common stock -- not only those engaged in the specific transactions criticized in the Staff Report.[4] The discussion which follows suggests alternatives which would be consistent both with sound tax principles and responsible fiscal policy.

1. One-Year Holding Period Proposal

The argument presented in the Staff Report in support of a change is that the current holding period requirement is insufficient to prevent corporate investors from artifically increasing their dividend receipts by repeatedly purchasing stock just prior to the dividend record date, and selling such stocks, ex-dividend, 16 days later. However, even assuming the need for some change, it is submitted that there is no rational basis for a one-year holding period. The stated rationale -- parity with the long-term capital gain holding period -- is misplaced because there is no relationship between capital gains and the dividends received deduction. A far more precise response is appropriate.

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[4] It is interesting to note that the evidence cited by the Staff Report in support of the need for a change in the holding period rule is a magazine article which questions whether any significant number of taxpayers are in fact engaged in such transactions.

The Committee should consider extending the holding period to 90 days. This is the normal period over which a dividend accrues, and a taxpayer who holds a stock for that period cannot generate artificial dividend income. On this basis, the investor will receive at most four dividends per year with respect to a given investment. This rule should end any abuses relating to the holding period, and, in our view, would not significantly affect either the capital markets or the ability of issuers to raise capital.[5]

2. Disallowance of Deduction For Interest Paid

The proposal to disallow 85 percent of interest expense attributable (under some mechanical formula) to the purchase or continued ownership of dividend paying stock requires a more complex analysis. The critical point is that the dividends received deduction is not a gratuitous windfall. Rather, it implements one of the basic tenets of our present income tax structure: that income generated by a business conducted in corporate form should be taxed only once at the corporate level and once at the individual level. The history of the dividends received deduction makes it clear that it is the tax on 15 percent of dividends and not the 85 percent deduction which represents a departure from the conceptually correct approach.[6]

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[5] This rule could, of course, be modified to deal both with normal dividend payments on a different schedule (e.g., semi-annual) and with payments of arrearages.

Only by ignoring this principle is it possible for the Staff Report to compare the deduction for dividends received to the tax exemption for interest received from municipal bonds. The differences are fundamental: funds used to pay interest on municipal bonds were not taxed to the municipality, whereas dividends paid by a corporate issuer have already been taxed to the corporation.

This analysis does not change if the dividend paying stock is purchased with borrowed funds rather than with retained earnings. In either case, the issuer has received funds from the sale of stock, and must use the earnings from such funds to pay dividends. These earnings will have been taxed once to the issuer; and, under the principle of one tax at each level, they should not be taxed again until distributed to individual investors. Contrary to this basic principle, the proposed denial of an interest deduction for debt incurred to buy dividend paying stock would effectively result in

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6. In general, a 100 percent dividends received deduction was allowed from the beginning of the corporate income tax through 1935. As part of the New Deal efforts to end holding company abuses, a deliberate decision was made to use the tax system to penalize multi-tier entities. In 1964, when the 100 percent deduction was restored for affiliated corporations which elected not to file consolidated returns, the only reason for limiting the deduction to 85 percent for nonaffiliated entities was to limit revenue loss. See generally, Schaffer, "The Income Tax On Intercorporate Dividends," 33 Tax Lawyer 161 (1979).

multiple corporate taxation of the earnings from which the dividends are paid.

Changes as significant as this go to the very heart of our federal income tax structure, and have far reaching economic policy implications as well. They cannot be dealt with summarily, or in isolation. Rather, if they are to be considered at all, they must be addressed only as part of a comprehensive package, which must address the issue of integration of the corporate and personal income taxes.

Summary of Conclusions and Recommendations

Our position may be summarized in four simple points:

First, the changes in the taxation of intercorporate dividends proposed in the Staff Report would cause massive disruptions in the nation's capital markets. Present holders of high-dividend stocks would suffer a loss of billions of dollars in the market value of their assets. Thereafter, issuers with a choice will issue debt rather than preferred stock, even though that will decrease their balance sheet liquidity and increase the risk of bankruptcy in times of economic adversity. The effect on companies, such as banks and utilities, which have no choice but to issue stock to satisfy capital requirements, will be even more serious; the inevitable erosion of their capital base will threaten important public interests.

Second, the proposed one-year holding period requirement has no practical or theoretical basis. If the Committee believes an extended holding period is necessary to prevent a specific abuse, the only logical choice is the period over which the dividend is earned -- 90 days in the case of a stock with a quarterly dividend.

Third, the proposed disallowance of a deduction for 85 percent of the interest expense incurred to purchase or carry stocks which produce dividends eligible for the dividends received deduction is inconsistent with the fundamental tenet of our tax system that income should be taxed only once at the corporate level. Any change in this principle should be considered, if at all, as part of a careful and thorough program of tax reform.

Fourth, any changes which are adopted must, in fairness to all current holders of stock, be made applicable on a truly prospective basis -- that is, only to stock issued after a fixed date in the future, rather than to all stock presently outstanding. Moreover, we think it is absolutely imperative that the Committee announce its intention to adhere to this principle at the earliest possible date.

The CHAIRMAN. Mr. Flaherty.

STATEMENT OF ROBERT T. FLAHERTY, FLAHERTY & CRUMRINE INC., PASADENA, CALIF.

Mr. FLAHERTY. I'm Robert Flaherty, president of Flaherty & Crumrine, an independent investment counsel firm. I've been heavily involved in the management of preferred stock portfolios for many years so perhaps what I can bring to this hearing is a view from the trenches.

My firm has no stake in leveraged preferreds or in dividend rolls as perceived by the staff to be abusive. Nonetheless, I am seriously concerned about the unintended and avoidable impact on the liquidity and the market value of preferred stocks to which Mr. Gallatin has already referred, and with which I concur.

In my opinion, abuses do exist which involve preferred stocks, But I think these are clearly the exception rather than the rule. I also think there is room for further analysis of the underlying transactions which should lead to specific remedies which address directly the abuses without side effects that harm the preferred stock market generally.

In particular, lengthening the holding period seems to me to be ill-advised, except in cases of unusually large dividends. The heart of the problem is more in what I would call paper dividends created through short sales. With proper action concerning some of the technical aspects of these dividends, created dividends, the holding period could, in fact, become a nonissue. That would be because the economic basis which presently allows dividend roll programs conceived solely for tax purposes to succeed would be eliminated.

Proper enforcement effort here involving current law would mesh well with the proposals which both the staff and the Treasury have made regarding payments made by short sellers to lenders of securities borrowed. I think those proposals are well taken, and should be pursued.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Robert T. Flaherty follows:]

FLAHERTY &
CRUMRINE
INCORPORATED

INVESTMENT COUNSEL

301 E. Colorado Blvd · Suite 720 · Pasadena, California 91101 · (213) 795-7300

October 14, 1983

Roderick DeArment,Chief Counsel
Committee of Finance
United States Senate
Room SD219
Dirksen Senate Office Building
Washington D.C. 20510

Dear Mr. DeArment:

I request an opportunity to testify before the "Hearing On Report On Reform Of Corporate Taxation" to be held on October 24, 1983. Specifically, I wish to comment on the proposals to be considered by the Committee on Finance, United States Senate concerning the extension to one year of the minimum holding period for stock on which dividends paid would be eligible for the dividends received deduction.

Although our firm was formed only recently, we are a major factor in the management of preferred stocks with roughly $250 million of such portfolios under our supervision. This represents a continuation of the work of our group at our former firm at which we were probably the largest manager of this sort in the country. As a matter of policy, we do not invest in "dividend rollover" programs or leveraged preferred stocks such as those at which the proposed changes in the law appear to be aimed.

We are very concerned about the unintended impact of the proposals on the liquidity of the preferred stock market. It is our belief that a much more specific approach is possible which would deal more effectively with the abuses identified without endangering the ability of this market to raise needed capital for important industries such as public utilities, banking and insurance. Our practical experience in the preferred stock market, which is independent of the underwriting and brokerage functions, should provide valuable perspective to the committee.

A summary of our thoughts on the proposed changes in the law is attached for your information. I would also appreciate being allowed to discuss this directly with the Committee Staff.

Very truly yours,

Robert T. Flaherty

cc: Honorable Pete Wilson
    Honorable Carlos J. Moorhead

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INVESTMENT COUNSEL
301 E. Colorado Blvd. · Suite 720 · Pasadena, California 91101 · (213) 795-7300

Comments on the Required Holding Period For Preferred Stocks

Liquidity is a very real problem for the preferred stock market despite the fact that this important sector of the capital markets raised almost $9 billion in new funds in the last year. Requiring a one year holding period for a stock to qualify for the dividend exclusion would challenge even a long term investor's ability to manage his preferred stock investments and to liquidate his portfolio in the face of changed circumstances. The need to commit to such a frozen protfolio would undoubtedly reduce sharply the number of participants in this market, thereby reducing market liquidity and increasing the cost of new capital raised by utilities, banks and others.

Although "dividend rollover" programs have been cited as an abuse, the fact is that the preferred stock market does not offer the liquidity necessary for an investor to buy a preferred just for a dividend, hold it for the minimum period of 15 days and then move on to repeat the experience in another preferred stock. In the real world, the costs of transactions can eat up the tax benefits.

It is important to look at the preferred stock market in the aggregate when considering the impact of the required holding period on tax revenues. In the absence of "mirrors", for every transaction there is an opposite side. If some investors receive "extra" dividends, others must give up dividends. If some achieve capital losses, others must realize capital gains. In total, these investors will pay the same federal taxes regardless of the holding periods.

Despite the foregoing, "dividend rollover" programs are taking place and are unquestionably causing a revenue loss for the Treasury which is primarily due to what we call "created preferreds". The simplest example of this is where A sells a preferred short to B and B sells a different preferred (with the same dividend date) short to A. To complete the short sales, the securities sold must be borrowed, and the short sellers must compensate the lender for the dividends which he has sacrificed. If the lender treats these payments as dividends subject to the exclusion then two exclusions will claimed for the same dividend (one by the buyer who receives it from the issuer and the second by the lender who receives his from the short seller.) In effect, the lender has transferred his tax benefits (i.e. the dividends received deduction) to another taxpayer without giving up the use of the tax benefit himself.

Since tax revenue is immune to the required holding period except for "created preferreds" stemming from short sales of borrowed stock, a more specific response would be to address the practice of lenders of preferred stocks claiming dividend exclusions for payments received from short sellers in lieu of dividends. In fact, this may merely require an enforcement effort under current law rather than a change in the law itself. Eliminating this duplication of dividend exclusions would precisely eliminate the financial basis which presently allows dividend rollover programs designed solely for tax purposes to succeed and would not involve either "overkill" or "underkill" in this relatively thin market.

Since the holding period for preferred stocks is not the heart of the perceived problem, it seems quite unnecessary to lengthen it and inflict significant losses of liquidity and market value on the great bulk of the investors in preferred stocks which would not even be shared by those whose offsetting long and short positions are responsible. The higher future cost of raising capital in this market would clearly be an undesireable result, particularly for the utility industry and all of its customers who would ultimately bear the cost.

STATEMENT OF WARREN Y. JOBE, EXECUTIVE VICE PRESIDENT, FINANCE, GEORGIA POWER CO., ATLANTA, GA.

Mr. JOBE. My name is Warren Jobe, and I'm executive vice president for Georgia Power Co. My summary comments here today are made on behalf of the Edison Electric Institute.

Excluding the Federal and State governments, the electric utilities, as an industry, are the largest public issuers of securities in this country. There are two proposals in your staff report which would have a material adverse effect on the financial markets in which our industry sells its securities. Such adverse effects would be translated into higher financing costs, and, in turn, would result in increases in the price of electricity.

The proposed change in the earnings and profits concept to a book income concept is not appropriate for the electric utility industry since it ignores the fact that about 55 percent of book income of these companies is represented by a noncash item of income referred to as the "allowance for funds used during construction."

In 1982, 20 major electric utility companies paid return of capital dividends. The existing rules, in effect, properly measure current cash earnings and profits. If abuses are pursued in this area, then we would agree with Treasury that the specific items should be dealt with on an individual basis. The proposed disallowance to corporations of interest on debt to purchase or carry stock investments effectively would result in the double or even triple taxation of corporate dividends.

Finally, if there are abuses related to the present 15-day holding period rule, the proposed 1-year rule would be an overkill. It would cause administrative problems. If abuses are perceived, a 30- to 60-day holding period should be considered.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Warren Jobe follows:]

Statement of the Edison Electric Institute

My name is Warren Y. Jobe. I am Executive Vice President-Finance for Georgia Power Company. I am privileged to submit this testimony on behalf of the Edison Electric Institute (EEI). EEI is the national association of investor-owned electric utilities in the United States. The member companies of EEI serve 99 percent of the ultimate customers of the investor-owned segment of the industry, comprising 77 percent of all electricity users in the country.

EEI appreciates the opportunity to comment on the proposals presented in the Senate Finance Committee staff's preliminary report on "Reform and Simplification of the Income Taxation of Corporations." We, as an industry, recognize that reform and simplification of the Tax Code is necessary, especially in a manner that eliminates abuses or results that were not initially intended. For that purpose the staff's preliminary report presents important topics for consideration. Two of the proposals however, will not accomplish the staff's reported purposes but will have an onerous and adverse financial impact on our industry and the adoption of these changes would result in higher prices for electricity to our customers both immediately and in the long-term. Specifically, the two proposals are:

- Repeal of the earnings and profits limitation, *i.e.*, the return of capital rule; and

- Increase in the holding period for the dividends received deduction and limitation of the deductibility of interest to purchase or carry stock producing dividends eligible for the dividends received deduction.

EARNINGS AND PROFITS

The staff report addresses two major issues relative to earnings and profits - "apparent abuses" and "complexity". We disagree with the conclusions and recommendations of the report on both issues.

The staff report describes four abuses of which one is considered primary. The report suggests that the most significant problem is that the general rules for computing earnings and profits yield improper results. An example of accelerated deductions and deferred income is given by the report to illustrate improper results. This conclusion is incorrect insofar as the electric utility industry is concerned. The matter of accelerated deductions providing tax free dividends, especially for the electric utility industry, was addressed by the Tax Reform Act of 1969 and subsequent legislation which limited depreciation for earnings and profits purposes to the straight-line method using lengthened lives. Other than depreciation, very few deductions can be described as accelerated. For the electric utility industry, most other deductions are prescribed by accounting methods and specific Code Sections. Moreover, the current procedures are based on economic reality and a shift from the principles of income and deduction recognition embodied in the Internal Revenue Code would ignore economic reality.

On page 102 of the report it is stated that in almost all real cases in which corporate distributions are to be made other than out of earnings and profits the special return of capital rules contained in the proposal would provide relief. We believe that by far and away the most important "real case" is not covered by these special rules. The electric utility industry is the most capital intensive industry in the United States. The construction program of the industry over the last decade has been enormous. During 1981 and 1982, the industry expended for new power facilities (plant) $32 billion and $36 billion respectively, and for 1983 it is projected that the industry will expend $38 billion. For the most part, utility commissions do not permit the utilities to earn current cash income on these billions of invested dollars while the plant is under construction. Most utilities therefore capitalize an amount (Allowance for Funds Used During Construction - AFUDC) as a cost of constructing plant. Unlike nonregulated industries, which through the market system adjust the current price of their goods and services to provide an acceptable return on their total investments, including construction projects, electric utilities capitalize AFUDC in order to be allowed to begin to recover it when the plant is placed in service. However, the investor who has purchased utility stock, thus providing construction capital, requires a return on his investment through current dividends even before the facility is earning a cash return. In accordance with generally accepted accounting principles, AFUDC is recognized as current income for financial reporting purposes. This is true even though the utilities do not receive cash currently for this income item. The utilities receive the earnings represented by AFUDC over the life of the constructed plant beginning when it is placed in service. As a result, there are often insufficient earnings and profits to support dividends especially during heavy construction periods, and therefore the dividends are properly treated as a return of capital. Because the utility has not received any cash and yet must pay dividends on funds used for contruction, these dividends are paid from general corporate funds. Obviously, there is no abuse with respect to such dividends and what in fact actually occurs is a return of capital. The AFUDC income reported for financial purposes is properly not recognized as either income or earnings and profits for Federal income tax purposes; income is not reportable until such time as it is realized.

For 1982, approximately 20 major investor-owned electric utilities had all or a portion of their dividends treated as a return of capital. These companies represent some 24 percent of the industry's total revenues and 32 percent of its total capital expenditure program. Also, of the $16.6 billion paid by the industry as dividends on common stock during 1981 and 1982, approximately $3.5 billion or 21 percent were a return of capital. For these same companies, 83 percent of their earnings were represented by AFUDC, while the industry average for 1982 was 54 percent.

The staff report states that a move to financial income would simplify the calculation. We do not agree with this conclusion because in consideration of fairness and equity, a substantial portion of financial income-AFUDC-is not realized income as defined by the Internal Revenue Code and clearly should not be considered as earnings and profits available for taxable dividends, Thus, a whole new series of rules and regulations will have to be devised for calculation procedures. To ignore this consideration would be untenable.

Attached hereto and described as Exhibit A is a list (as of August 10, 1983) of electric utilities which pay a return of capital dividend. These companies have very large construction programs; in order to continue such construction programs they must continue to sell common stock, preferred stock and long term-debt. An elimination of the earnings and profits limitation as proposed would only serve to increase the cost of financing which in turn would increase the cost of electricity.

Generally speaking, those electric utility companies which are currently paying return of capital dividends are the same companies which have the largest construction programs and consequently, are required to issue the largest amount of new stock to finance such programs. Many investors find these stocks attractive for the return of capital dividend. To change the return of capital rules during this time of heavy equity financing would be very detrimental to these companies.

The present rules with respect to earnings and profits do work fairly for utilities. These rules are known within the investment community and should be continued. If there is perceived to be a specific abuse, that abuse should be dealt with directly.

DIVIDENDS RECEIVED DEDUCTION

The staff report addresses certain abuses that exist because of the current 15 day holding period for corporate shareholders. Although abuses may be determined to occur, we believe the proposal for a one year holding period goes beyond what may be needed. A one year holding period would add complexity to the determination of the dividends received deduction and also reduce much needed liquidity in the financial markets causing many investors to seek other investments. This would result in a higher cost of capital to this industry. We believe a holding period of 30 to 60 days may be more reasonable.

The staff report proposes to disallow interest on debt incurred to purchase or carry stock producing dividends eligible for the dividends received deduction applicable to corporate shareholders. The staff report lists arguments for and against the proposal. The arguments against the proposal, in our opinion, have much more merit than the arguments for the proposal.

Of the arguments listed for the proposal, the only one relative to tax avoidance is the incorrect one of "tax shelter benefits". Of the arguments listed against the proposal, the most important is the issue of multiple taxation of corporate earnings. The essence of the problem is - which is the correct position? We believe that the dividends received deduction is necessary to prevent the inequities of multiple taxation of corporate earnings. The position that a tax shelter exists is incorrect. To the extent that a corporation claims an interest deduction on debt incurred to carry corporate stock, another taxpayer in most cases will report taxable income; therefore, a wash occurs. The dividend received by the corporation will eventually be taxed in most cases when distributed to its shareholders. Thus, a tax shelter does not exist.

On the other hand, enactment of this proposal with respect to the deductibility of interest would have the effect of multiple taxation. For example, earnings would be taxed at the corporate level as accrued, then these same earnings would be taxed to a corporate shareholder as distributed and then taxed again to individual shareholders when later distributed. In light of the well documented shortfall of capital formation in this country, we believe that this is not the direction in which the tax law should be moving.

As stated above, this proposal pertaining to the deductibility of interest will have an adverse effect on capital formation. The proposal, which has the effect of reducing the dividend received deduction, would severely penalize the electric utility industry's efforts to raise much needed capital. Common and preferred stock accounted for approximately $127.4 billion or 50.7 percent of the total capitalization for the investor-owned electric utility industry on December 31, 1982, and in 1982 new common and preferred offerings accounted for approximately 45 percent of all new electric utility industry financing. Thus, equity capital is an important source of capital for the electric utility industry. The dividends received deduction is a major consideration to the corporate investor in determining the yield that it requires, and the corporate investor provides a significant market for our equity issues. The yield required by investors on preferred stock can be up to 2 percentage points (200 basis points) less than that which is required on equivalently rated long-term debt. Thus, preferred equity is a cost effective method of financing construction expenditures.

The repeal or the effective repeal of the dividends received deduction would penalize utilities by significantly increasing the future yields required by certain investors. Thus, the utility industry's cost of capital would increase and in turn the price of electricity to its customers would increase. In addition, the repeal or the effective repeal of the dividends received deduction and applying the change to existing shareholders would severely penalize many existing shareholders by driving down their after tax yield and hence the principal value of their investment which they entered into in good faith and cause significant disruption in the financial markets. Furthermore, many utilities have tax indemnification clauses which, if applicable, would require the issuing utility to either increase the dividend rate or refinance the issue. Either remedy would increase the cost to the utility and its ratepayers and would place increased requirements on already restricted capital markets.

Exhibit A

Smith Barney
Harris Upham
& Co.
Incorporated **research**

utilities digest

Release date: August 10, 1983

Daniele M. Seitz
(212) 399-6071
Jeffrey J. Hoffman
(212) 399-6262
Roger J. Khlopin
(212) 399-8408

UTILITY COMMON STOCKS
TAX STATUS OF 1983 DIVIDENDS - PRELIMINARY ESTIMATES

The following list is the result of a recent SBHU survey conducted to determine the major electric utilities preliminary estimates of the return of capital portion of their 1983 dividends. The percentage figures shown for 1982 are final company estimates, but will not be definitive until the companies 1982 tax filings are audited by the Internal Revenue Service. The discussion below reviews the basis of return of capital dividends and, why it occurs with electric utilities in particular.

Return of capital treatment of dividends arises whenever a company's net-of-tax cash income is insufficient to cover dividend requirements. In general, this is caused by differences between reported income for tax purposes and reported income for shareholder purposes. For industrial companies this is most often a function of timing differences in depreciation and amortization rates for shareholder and income tax purposes. An additional factor in the case of electric utilities is that reported income includes a noncash credit known as allowance for funds used during construction (AFUDC). While this credit is reported as income for shareholders purposes, it is not considered income for IRS purposes. The result is that many utilities earn insufficient after-tax income to pay their dividends. Thus, from a tax standpoint dividend is paid out of retained earnings or equity capital. For example, if a company has after-tax income (as audited by the IRS) of $100 and pays out $150 in dividends, $50 ($100 minus $150) of the dividend, or 33.3% is viewed as a return on capital. Since the return of the equity capital lowers the purchase price of the stock for tax purposes, the return of capital dividend is taxed at the same rate as any appreciation in the stock. Thus, if the stock is held 12 months or longer the tax benefit arises from the capital gains rate being lower than the current income tax rate, which is the basis on which dividends are normally taxed.

ROC dividends from electric utilities are expected to decline in the next few years. The completion of generating units now under construction should result

This study is not a complete analysis of every material fact respecting any company, industry or security. Opinions expressed are subject to change without notice. Statements of fact have been obtained from sources considered reliable but no representation is made as to their completeness or accuracy. This Firm or persons associated with it may at any time be long or short any securities mentioned in the study and may from time to time sell or buy such securities. This Firm or one of its affiliates may from time to time perform investment banking or other services for, or solicit investment banking or other business from, any company mentioned in the study.

[illegible] Smith Barney, Harris Upham & Co. [illegible]

in more manageable financing needs and lower AFC/income industry ratio. This, in turn, should improve electric utilities' quality of earnings and coverage of dividend.

Among the stocks listed in Table I, we favor New York State Electric and Gas - NGE (NYSE-19), Long Island Lighting - LIL (NYSE-15) and Union Electric - UEP (NYSE-15) for superior after tax overall return.

Basic Advantages of ROC Dividends

For the investor, return of capital dividends results in two basic tax advantages:

1) No tax payment is required on the return of capital portion of the dividend until the stock is sold.

2) The return of capital portion of the dividend is taxable at the capital gains rate when the stock is sold if held for 12 months or longer. It is deducted from the cost basis of the stock for tax purposes. Tax payment is therefore lower than if it were considered as ordinary income.

NOTE:

A recent Treasury proposal is attempting to establish new reporting guidelines for companies in an eligible dividend reinvestment plan. If passed, this new reporting method could result in an increase in the 1982 and 1983 ROC portion of capital dividends for several companies. A final ruling on this proposal is expected in September.

RETURN OF CAPITAL (ROC) DIVIDENDS

Company	Symbol	Price as of 8/2/83	Current Div.	Current Yield	Div. Paid in 1982	ROC PORTION OF DIVIDEND					
						1982	1981	1980	1979	1978	1983E
American Electric Power#	AEP	$18 3/4	$2.26	12.1%	$2.26	24.0%	43.8%	29.0%	34.0%	73.0%	0-20%
Arizona Public Service	AZP	24 1/8	2.60	10.7	2.40	10.0	27.0	61.7	27.3	-0-	20-40
Bangor-Hydro#	BANG	13 5/8	1.56	11.6	1.53	100.0(1)	-0-	100.0	50.0	-0-	90-100
Central Hudson Gas & Electric	CNH	23 1/4	2.60	11.2	2.48	-0-	7.0	90.0	-0-	-0-	-0-
Cleveland Electric Illuminating	CVX	19 1/8	2.28	11.9	2.19	-0-	49.0	100.0	25.5	47.0	-0-
Commonwealth Edison#	CWE	25 5/8	3.00	11.7	2.80	-0-	45.0	92.0	92.0	46.3	60
Consumers Power	CMS	18 1/4	2.44	13.4	2.44	100.0(2)	53.0	81.5	-0-	-0-	100
Dayton Power & Light	DPL	16 7/8	2.00	11.9	1.90	-0-	12.4	84.9	69.8	-0-	-0-
Detroit Edison#	DTE	14 1/4	1.68	11.8	1.68	63.0	75.0	100.0	-0-	-0-	0-20
Dominion Resources	D	21 5/8	2.40	11.1	1.325	88.47	40.22	100.0	77.8	-0-	0-20
Duquesne Light	DQU	16 5/8	2.00	12.1	1.90	22.76(3)	-0-	70.0	-0-	-0-	10-20
El Paso Electric#*	ELPA	14	1.34	9.5	1.31	60.0(4)	-0-	-0-	-0-	-0-	30-40
Kansas Gas & Electric	KGE	19 1/2	2.24	11.5	2.15	86.0	61.0	86.0	-0-	-0-	75
Long Island Lighting	LIL	15 1/2	2.02	13.1	1.98	100.0(5)	63.0	100.0	100.0	70.0	100
Middle South Utilities#	MSU	15 1/8	1.70	11.2	1.66	92.0	98.0	98.2	27.6	-0-	70-90
New York State E & G	NGE	19 3/4	2.32	11.8	2.10	-0-	-0-	100.0	5.6	22.0	40-50
Niagara Mohawk Power	NMK	17	1.92	11.2	1.76	30.0	10.0	65.0	65.0	27.1	-0-
Northeast Utilities#	NU	12 3/8	1.38	11.2	1.28	-0-	24.0	89.0	15.4	-0-	-0-
Northern Indiana PS	NI	13 1/8	1.50	11.4	1.50	65.0	25.0	-0-	-0-	-0-	20-30
Ohio Edison	OEC	14 5/8	1.80	12.4	1.76	75.0	100.0	100.0	72.0	100.0	74
Pacific Gas & Electric#	*PCG	15	1.60	10.6	1.43	-0-	81.1	-0-	100.0	-0-	-0-
Pacific Power & Light#	PPW	22	2.16	9.8	2.16	45.0	-0-	45.0	50.0	-0-	-0-
Pennsylvania Power & Light	PPL	22 1/4	2.40	10.8	2.30	100.0(6)	100.0	100.0	60.8	7.1	50
Philadelphia Electric#	PE	16 3/4	2.12	12.7	2.06	-0-	56.0	45.3	99.0	41.0	0-50
Portland General Electric	PGN	14	1.78	12.7	1.74	-0-	-0-	63.0	100.0	100.0	NA
Public Service of New Hampshire	PNH	16 1/2	2.12	12.9	2.12	100.0(7)	100.0	100.0	68.0	-0-	100
Public Service Electric & Gas#	PEG	23 1/8	2.64	11.4	2.53	-0-	88.3	79.3	40.5	74.2	-0-
Puget Sound Power & Light	PSD	13 1/4	1.76	13.3	1.76	100.0(8)	8.0	47.0	-0-	-0-	25-50(9)
Toledo Edison	TED	19 7/8	2.44	12.3	2.36	66.7	45.9	100.0	52.5	14.7	40
United Illuminating	UIL	25 7/8	3.08	11.9	2.88	-0-	36.0	84.0	65.0	30.2	10-20
Union Electric Power	UEP	14 7/8	1.64	11.1	1.58	70.0	82.5	-0-	-0-	-0-	70-80

Footnotes:

(1) BANG - Preferred - 100% ROC
(2) CMS - Preference - 95% ROC; Preferred - 0% ROC
(3) DQU - Comm. Jan. Div. - 13.44% ROC, Apr. July, & Oct. Div. 25.87% ROC
(4) ELPA - Comm. Mar. Div. - 31% ROC, Jun. Sept & Dec. Div. - 63% ROC
(5) LIL - Preferred - 82% ROC
(6) PPL - Preference - 100% ROC; Preferred 65.61% - ROC
(7) PNH - Preferred - 100% ROC
(8) PSD - Preferred - 100% ROC
(9) Could be 100% if the company cancels the Skagit nuclear unit in 1983
* After stock split

Within the last three years, Smith Barney, Harris Upham & Co., Incorporated or one of its affiliates was the manager (comanager) of a public offering of the securities of this company and/or has performed other investment banking services for which it has received a fee.

* Smith Barney, Harris Upham & Co., Incorporated usually maintains a market in the securities of this company.

STATEMENT OF SCOTT W. JOHNSON, VICE PRESIDENT, INVESTMENT BANKING DIVISION, GOLDMAN, SACH & CO., NEW YORK, N.Y., ON BEHALF OF SECURITIES INDUSTRY ASSOCIATION, WASHINGTON, D.C.

Mr. JOHNSON. Mr. Chairman, my name is Scott Johnson, and I am a vice president of Goldman, Sach & Co. I am testifying today on behalf of Goldman, Sach and on behalf of the Security Industry Association.

We believe that the staff proposals concerning the corporate dividends received deduction would have a seriously damaging effect on the preferred and utility common stock market.

As an example, we estimate that the proposals would cause the utility ratepayers at least $800 million a year in higher utility rates needed to cover, after a period of 5 years, the higher cost of stock financing. In addition, we estimate that the value of utility common stocks would fall by more than $20 billion as a result of the proposals.

That most of this loss would be experienced by individuals, largely retired persons, who hold these stocks. In contrast to these costs, the staff has estimated that the revenue benefit to the U.S. Treasury would amount to no more than $250 million in 1984 and $550 million in 1986.

Goldman, Sach and the Securities Industry Association recommend that a scapel approach be devised to address any specific abuses of the dividends received deductions rather than the very broad and potentially very damaging approach which has been proposed.

The Securities Industry Association would like to work with the staff in developing such an approach.

We thank you for this opportunity to present our views.

The CHAIRMAN. Thank you very much.

[The prepared statement of Barrie a Wigmore follows:]

Goldman, Sachs & Co. | 85 Broad Street | New York, New York 10004
Tel: 212-902-5272

Barrie A. Wigmore
Partner

Goldman
Sachs

October 17, 1983

Committee on Finance
United States Senate
c/o Mr. Roderick A. DeArment
Chief Counsel and Staff Director
SD 219
Dirkson Senate Office Building
Washington, D.C. 20510

Gentlemen:

We are writing to express our concerns relating to proposals by the staff of the Committee on Finance of the United States Senate relating to the minimum holding period for stock on which dividends paid would be eligible for the dividends received deduction and to the disallowance of interest on debts incurred to purchase or carry such stock. We believe that the staff's proposals, as contained in its report entitled "The Reform and Simplification of the Income Taxation of Corporations" would be damaging to both the preferred stock market and the common stock market. The impact of these proposals would be particularly severe on utility companies and investors in utility company common and preferred stock, because utility companies have been important issuers of preferred stock and because utility company common stocks as a group trade on the basis of their relatively high current dividend yields.

Potential Impact on Utility Common and Preferred Stock Markets

The likely impact of the staff's proposals on the yield levels required by investors for utility common stock and for preferred stock in general is difficult to quantify. However, our best estimate is that utility common stock yields might rise by 100 to 150 basis points above current levels, implying price declines of perhaps 10%. For preferred stocks we would estimate the potential increase in yield levels at approximately 100 basis points, with a similar impact on price levels. These price level effects would be accompanied by, and to some extent caused by, lower levels of trading volume and lesser liquidity, especially in preferred stock.

The effects which the staff's proposals would have on tax paying corporate investors are the root cause of these price and liquidity effects. For many of these investors, the damage to liquidity imposed by the proposed one-year holding period will be sufficient to take them out of the preferred stock and utility common stock markets. We estimate that as much as 40% of the current buying power for preferred stocks would be eliminated. Adjustable rate preferred stocks, which have become especially popular among banks and utility companies in the last two years, and which have been purchased largely by corporate, short-term investors with a great need for liquidity, would be especially vulnerable to loss of investment appeal. Corporate investors in utility common stock, which we estimate to compose roughly 25% of that market, would likewise be largely displaced.

The effect of the disallowance of interest on debt incurred to purchase stocks would also have a negative effect, but this is even harder to quantify, particularly in the absence of knowledge of the specific rules which will govern which debt is subject to the disallowance. However, we know that the preferred stock market is dominated by taxable corporate investors, and this category of investors also plays a significant role in the utility common stock market. Most of them have debt on their balance sheets, including in many cases a significant amount of seasonal debt. To the extent that all or part of this debt is considered under any new rules to be incurred to carry a portfolio of common or preferred stocks, these investors will have a new disincentive for investing in these stocks, since they would lose some amount of interest deduction. As a result, they will either seek other investment opportunities or will require higher yields on stock investments.

Effects on Utility Companies and Their Ratepayers

The capital formation process, especially for utility companies, would be impaired in a variety of ways:

1. Higher Cost of Capital. The new issue cost of preferred stocks would rise in line with the yields on outstanding issues of preferred stock and common stock. As these higher costs become imbedded in utility capitalizations, a result will be larger requirements for customer rate increases. New issues of utility common stocks and utility preferred stocks since 1978 have totalled over $27 billion and $12 billion, respectively. As an illustration, a 1% increase in the cost of the cumulative amount of total stock financing in this period would require additional revenues from utility customers of nearly $800 million annually, assuming a 50% combined Federal, state and local income tax rate.

2. Diminished Access to Preferred and Common Stock Financing. Because of the loss of a significant portion of the current demand for utility stocks, the ability of utilities to finance with common and preferred stock issues in large size would be hurt. This effect would vary widely from one company to another, with those utilities whose stock yields are highest, and whose financial condition is often the weakest, being the most adversely affected. If utilities must make smaller offerings, then they will have to finance more frequently, thereby increasing their total financing transaction costs.

3. Less Financing Flexibility. As mentioned above, adjustable rate preferred stocks may lose much of their appeal as investments, and therefore also as a financing vehicle for utility and non-utility companies. The attractiveness of more traditional sinking fund and perpetual preferred stock financings may also be diminished. The combined effects which the proposals are likely to have on financing size limitations and on yield levels may be sufficient to lead many utility companies to choose other financing alternatives.

   A shift away from preferred stock could compound the problem of higher utility customer rate requirements caused by higher yield levels. Preferred stock is typically considered as an alternative to common stock financing because it is generally a more expensive form of financing than straight debt but is usually viewed as equity by the credit rating agencies. If utility companies turn increasingly to common rather than preferred stock, the higher cost of the common stock could lead to even higher customer rate increases.

Effects of Investors

The adverse effects on investors in terms of loss of market value and liquidity would also be severe:

1. Loss of Market Value. The potential losses which might be suffered by investors is substantial. Using a hypothetical 10% market price decline as an illustration, investors in those utility common stocks listed on the New York Stock Exchange would suffer losses of approximately $20 billion. Most of this loss would be suffered by individual investors, largely retired persons who have bought utility stocks for their high yields. For preferred stocks listed on the New York Stock Exchange a 10% value loss would amount to approximately $1.3 billion.

2. Loss of Liquidity. In addition to significant potential losses, investors would suffer from the reduced ability to sell stocks quickly and without affecting the market price level. As a result of lower trading volume and fewer buyers, especially in preferred stocks, the spread between bid and asked prices can be expected to widen and particularly large trades would be more difficult to execute. Hence, the overall efficiency of the trading markets, especially in preferred stocks, would be reduced.

The staff's proposals, in attempting to eliminate a relatively narrow range of investing practices believed to be abuses of the tax law, risk much broader and potentially very damaging effects on the capital formation process, on utility ratepayers, and on common and preferred stock investors in general and utility stock investors in particular. We urge you to consider the proposals in the light of their potentially damaging effect on capital formation.

We are pleased to have this opportunity to express our views and would be happy to respond to any inquiries concerning our comments.

Sincerely,

Barrie A. Wigmore

Barrie A. Wigmore

BAW:sac

The CHAIRMAN. Does Goldman, Sach recommend to their clients the use of the dividend roll?

Mr. JOHNSON. We execute transactions for some of our clients that could be described as a dividend roll.

The CHAIRMAN. Do you recommend them?

Mr. JOHNSON. I think for certain companies we would recommend that as an appropriate strategy under current law, yes.

The CHAIRMAN. Have you done substantial trade in Chrysler preferred stock in the past month for corporate clients?

Mr. JOHNSON. I don't know the answer to that question without checking. We do not have a position in the Chrysler preferred stock. It's possible that we could have executed trades for some of our clients.

The CHAIRMAN. Have you lent of the Chrysler preferred stock to your clients who are selling short?

Mr. JOHNSON. I would have to get an answer to that.

The CHAIRMAN. Mr. Jobe, can you quantify what portion, if any, is the nontaxable distributions made by your industry which would be affected by the proposals or made by corporations which pay no tax and report profits for a financial purpose?

Mr. JOBE. I don't have that information, but I will be glad to provide it.

The CHAIRMAN. If you would just provide that for the record.

[The information from Mr. Jobe follows:]

RESPONSE TO SENATOR DOLE'S QUESTION TO MR. WARREN JOBE AT THE SENATE FINANCE COMMITTEE HEARING, OCTOBER 24, 1983

Question. Mr. Jobe, can you quantify, for corporations of your industry which pay no tax but report financial income, what amount of non-taxable distributions would be affected by the proposals?

Answer. In 1982, twenty electric utility companies paid dividends which were totally or in part treated as return of capital dividends. Of these companies, 10 companies reported income in their 1982 financial statements, but had no current Federal income tax provision. Generally speaking, these companies have very large construction programs, and they are not recovering the financing costs associated with these construction programs through current electric rates. Instead of providing for current recovery of such financing costs, regulatory commissions have required these companies to capitalize an "Allowance for Funds Used During Construction" (AFDUC) as a part of the total construction cost and to treat such items as income for financial reporting purposes (a non-cash item). AFUDC is a non-cash income item, and it does not provide cash for dividend payments. For these 10 companies, AFUDC represented 92% of their 1982 reported net income. AFUDC is not treated as taxable income, until such time as it is realized in cash. These 10 companies paid cash dividends on their preferred and common stock in 1982 totaling $1.527 billion, of which $1.230 billion was treated as return of capital.

The CHAIRMAN. I think this panel, as we have indicated to other panels—we understand there is going to be opposition to any change, particularly if it's a pretty good deal that you have got. We will proceed on the basis that we will not have complete agreement on this project. But we are going to try to work out some of the problems.

I think if we had a prospective announcement, as you suggest, that we might as well just forget that whole section. Nothing would ever happen.

Mr. GALLATIN. Senator, I think the prospective announcement we were hoping for would just indicate that there would be no retroactivity so that there would not be any effect on trading at the moment.

The CHAIRMAN. I'm going to investigate that request.

Mr. GALLATIN. Thank you.

The CHAIRMAN. Not investigate, but consider it because I can understand your concern. But I haven't had a chance to do that in the few minutes since you have raised it.

But we will be working with every group who has an interest. We are not approaching this in any hostile way. This is an effort that has finally been concluded after 8 to 10 years to study that we think deserves consideration. It's been a bipartisan effort at the staff level so it's not any effort to single out any industry.

But we do have an obligation, in my view, to keep looking at some of the abuses and misuses. And even though they may be justified under the code, they are generous provisions that ought to be addressed. We try to do it in every other program. So we hope that when the bill is introduced and you finally have the legislation that maybe you will want to come back and testify or you may be so happy with it that you won't even want to show up. Somehow I doubt that.

There are serious questions that we need to focus on.

Thank you very much. You can just provide those answers for the record.

Our final panel is Raymond Plank, chief executive officer and chairman of the board, Apache Corp.; George S. Slocum, executive vice president and chief financial officer, Transco Energy Co.; Lewis H. Sandler, general partner, Southwest Realty, Ltd.; and Warren Hood, general partner, AFH Partners, Jackson, Miss., on behalf of Timber Realization Co., Jackson, Miss.

I would ask the recorder in giving names to please give full explanations of the witnesses.

My colleague, Senator Danforth, has joined the hearing. I have to leave here in a minute or two. But I, again, welcome the panel. As I have said to other panels, we are hearing testimony only on the recommendations of the staff report. We can understand the interest of those who have testified. There will be legislation introduced; some, of course, may fall by the wayside. We may not be able to agree on staff recommendations. That's why we are having this hearing up front.

So we can start with Mr. Plank.

STATEMENT OF RAYMOND PLANK, CHIEF EXECUTIVE OFFICER AND CHAIRMAN OF THE BOARD, APACHE CORP., MINNEAPOLIS, MINN.

Mr. PLANK. Mr. Chairman, I have submitted to the staff a brief statement which I had been prepared to present today in opposition to the proposal to tax publicly traded limited partnerships as corporations. In the interest of time constraints, I shall summarize even that brief statement.

The partnership has been for many years an essential mechanism for attracting needed equity capital to America's priorities, which have included oil and gas exploration, research, and real estate as job providing industies. Most of these higher risk investments would not have occurred and will not occur in the future if they are required to be made in the form of investments in corporations. The publicly traded limited partnership is an outgrowth of the traditional illiquid partnership for raising capital and is a much more efficient format, for example, for the oil and gas industry and for other specialized industries which Congress encourages.

Apache Petroleum Co., our publicly traded partnership, has not cost the Government tax money. In fact, it has substantially increased tax revenues available to the Treasury by economic activity which includes a number of factors. For example, when a limited partnership goes public through an exchange, percentage depletion is lost by the individual who transfers his properties into the limited partnership.

Additionally, by virtue of liquidity, the investor at the time he sells his now publicly traded unit—that investor pays not only a capital gains tax but is subject to recapture. Again, through the process of liquidity. Therefore, the publicly traded limited partnership has made it possible for small investors to make lower risk investments after the assets have been appraised and after market liquidity has been established than would have been the case without these forms of investment.

The recent amendments to the code, which provide for a centralized audit for partnerships, combined with sophisticated computer programs developed by the publicly traded partnerships and major accounting firms, have virtually eliminated the prospect of administrative and audit problems as apparently feared by some. Publicly traded partnerships are quite prepared to work with the Treasury and IRS to solve any remaining perceived problems.

A Forbes article, which appears to have stimulated in large part the proposal, is lurid journalism which does not analyze the issues involved. There is no threat to disincorporate America. To the extent the limited partnership format becomes more attractive in those areas where it is not presently being used, the implications for tax policy can be considered over time in deliberate fashion. Meanwhile, the marketable partnership affords the investor in previously illiquid partnerships an avenue to sell the investment, incur a tax at the time of his or her choosing, freeing that capital for job productive commerce.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Raymond Plank follows:]

Statement
of
Raymond Plank
Chairman and Chief Executive Officer
Apache Corporation
before
Committee on Finance, United States Senate
at
Hearings on
The Reform and Simplification of the
Income Taxation of Corporations
October 24, 1983

My name is Raymond Plank. I am Chairman and Chief Executive Officer of Apache Corporation, a New York Stock Exchange listed corporation engaged in the oil and gas business. Apache is sole General Partner of Apache Petroleum Company ("APC"), a publicly traded New York Stock Exchange listed limited partnership engaged in the exploration, development and production of oil and natural gas in the continental United States. I appear today in opposition to the proposal in the Senate Finance Committee Staff Report ("Report") that publicly traded partnerships should, by virtue of that characteristic alone, be taxed as corporations.

Mr. Chairman, I have spent over 25 years in the business of raising equity funds from public investors and reemploying those funds in job and energy-producing operations. This investment has helped enlarge the domestic oil and gas reserves of this country and has provided jobs throughout the gas and oil producing states. Since 1981 alone, we have paid into the U.S. Treasury $66 million for lease bonuses in the Gulf of Mexico alone, plus several million dollars per month into state treasuries in separation taxes and royalties. I founded Apache Corporation in the mid-50s not only to engage in the oil and gas business itself but also to serve as the sponsor and managing general partner of a series of public partnerships that have provided this essential equity capital for the oil and gas business. From 1959 to the present, Apache has sponsored 64 public partnerships. These programs have involved 30,000 investor/ partners and have raised over $700 million for investment in oil and gas exploration and production.

It is important to understand that, during these turbulent years for energy consumers and producers within the oil and gas business, much needed fresh equity capital was largely made available to the American domestic oil and gas industry by investment through partnerships. The industry was not, and is not today, capable of raising this equity capital solely -- or even primarily -- through the issuance of corporate stock. The reason for this is clear. The oil and gas industry has been, and is, an industry for which Congress has traditionally provided substantial accelerated income tax deductions, available at both the corporate and individual level, to attract needed investment. As a general rule, individual investors in oil and gas are not willing to put their money at risk unless the accelerated tax deductions are made directly available to them in order to reduce the amount at risk. Only investments through partnerships enable this to be done, and therefore, they are a preferred form of investment for the independent oil and gas companies that conduct more than 80% of domestic exploration and drilling.

Public partnerships today constitute the major vehicle for obtaining equity investment in oil and gas from public investors. Consider recent statistics: of all oil and gas cash securities offerings registered with the SEC in 1981, about 55% (over $4 billion in dollar investment) was in limited partnership form. In 1982, the comparison is even more dramatic: about 83% (over $6 billion in dollar investment) was in such form. And our continuing need for such capital is demonstrated by the ominous fact that in 1983 the level of domestic oil and gas reserves is expected to fall for the second straight year. Oil and gas corporations -- with their stock generally selling at a substantial discount from underlying asset value -- cannot market equity participation because to do so would unacceptably dilute existing shareholder equity. It is overwhelmingly clear that, in my industry at least, much equity investment would not have been made at all if not made in the partnership form. I can certainly report from my own experience that the investments that have since 1959 been placed in our programs, and since 1981 in APC, would not have been made at all if the investors had been required to buy stock in a corporation.

In 1981, we at Apache served as general partner of thirty-odd public partnerships, some of which had undeveloped reserves and limited financial capacity and others had such capacity but limited upside potential. It was altogether clear to us that, in order to stimulate further development of these reserves and values to our investors, it was necessary to consolidate these partnerships in a single partnership with much greater financial strength and a capacity to undertake further development. This we did, by giving our investors the option -- which they exercised in overwhelming numbers -- to exchange (or "roll up") their existing units for new partnership interests in APC, which units were then listed on the New York Stock Exchange. However, APC was, and is, in all respects a partnership, formed under the Texas Uniform Limited Partnership Act and falling squarely within the definition of a partnership contained in Treasury regulations (the Internal Revenue Service issued us a favorable ruling to this effect, as it has done to several other publicly traded partnerships).

I am happy to report that the market response to APC since 1981 has been excellent. Our reserves are approaching $1 billion. We have made a second successful exchange offer. We have made substantial acquisitions of oil and gas properties in exchange for units and have successfully sold in the market over $80 million in new partnership units. Today, APC has a balanced and diversified program of exploratory and development drilling and the operation of income-producing properties. Over 80% of our drilling is developmental.

Mr. Chairman, let me also comment on two additional aspects of APC. First, the new characteristic of liquidity that APC has brought to the partnership form of doing business -- one of two corporate-like characteristics a partnership is allowed to possess -- has created a far more effective vehicle for raising capital in the marketplace for the oil and gas industry than ever existed before. Second, we have opened the market not only to affluent investors who can afford to pay large sums for, and hold on to, illiquid investments, but we have offered a safe and liquid investment unit to small investors. Mr. Chairman, I believe that Apache, in creating APC, has demonstrated an innovative response to the problem of better raising capital in a volatile investment area. This accomplishment is solidly in keeping with the American tradition of finding better ways to make the free enterprise system work.

Now the Report proposes to turn back the clock. As far as I can tell, it appears to base this proposal on two arguments: publicly traded partnerships are "too similar" to corporations not to be taxed as corporations; and "substantial questions" have been raised whether the partnership "pass through" rules work effectively for publicly traded partnerships. Let me deal with these questions from the point of view of the actual experience that we have had with APC.

I must suppose that the argument that partnerships must be taxed like corporations has something to do with the fear of revenue loss if they are not. I can report to you that the creation and subsequent operation of APC has resulted in more total income tax being paid to the Federal Government than would have been the case if the investors had not acquired APC units. As a consequence of our exchange offers, our original investors forewent substantial amounts of percentage depletion when they exchanged their old interests for tradable units; many of them (who could not otherwise have done so) subsequently have sold their new units not only subject to capital gains tax but also at the cost of being taxed on substantial amounts of income tax "recapture" of such previously deducted items as intangible drilling costs and the investment tax credit. What happened is not surprising: the creation of a new and more effective vehicle for putting capital to work in the oil and gas industry has not only stimulated production and jobs but has produced taxable income for the Government that would not otherwise have resulted. Just as the reduction of the capital gains tax rate in the first year of the Reagan Administration demonstrably produced an increase in total tax receipts from capital transactions, so too has APC stimulated an increase in tax receipts from the ownership of partnership units.

Let me express concern, in passing, that the Report has apparently relied on a recent article in Forbes magazine to support its recommendation, on the grounds that increasing use of tradable limited partnerships will lead to the "disincorporation of America." This was an inflammatory piece of journalism that did not purport to analyze the issues involved. The sensationalism expressed in the Forbes article simply does not, in my judgment, generate substance. I have had 30 years experience managing limited partnerships and I believe I can assure this Committee that for a variety of reasons, this form of doing business does not recommend itself as a satisfactory alternative to the corporation in most commercial and industrial areas. Again, let us look at the facts: in 1981 of all cash securities offerings made by limited partnerships that were registered with the SEC, slightly over $4 billion were oil and gas, $4 billion were real estate and about $3 billion were all others; in 1982, over $6 billion were oil and gas, $2.5 billion were real estate and about $2 billion were all others. Many tax people tell me that the tax costs of "disincorporating" most existing corporations would make conversion to the limited partnership format unfeasible. For a variety of reasons that I will further develop in supplemental testimony I expect to file with this Committee, I believe that material reasons exist why investors will not be generally attracted in the case of new investment to limited partnerships, except where they are offered accelerated deductions and, in most cases, an assured cash flow. Forbes notwithstanding, this Committee should not conclude, in haste, that there is any immediate threat to the corporation as the principal method of conducting business in the United States.

When an individual or corporation merges or exchanges oil and gas holdings for units in our partnership, that party does not avoid a tax presently being paid -- it increases the liability via lost statutory depletion. This is in marked contrast to royalty trusts, which generally remove income from corporations and limit the resulting taxable revenues to a single tax. And now, when our APC units are sold or passed by death, the visible values of the gain are taxed.

The Report also alleged that substantial administrative (and presumably audit) problems are presented by the public trading of partnership interests. A few years ago, this argument might have had some substance: the tracking, locating and taxing of innumerable partners holding tradable units might well have presented difficult administrative problems, both for the general partner and for the Internal Revenue Service. But Congress has recently modernized and updated the rules. It first provided rules extending the statute of limitations for assessing the tax liabilities of partners in "federally registered partnerships."

Then, and most importantly, in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), provision was made for a "centralized audit" procedure that, as a practical matter, allows the determination of partners' tax liabilities at the partnership level. In this new framework, we have ourselves spent over $2 million to develop a sophisticated computer system that permits us to identify and communicate satisfactorily with all our partners in the dissemination of tax information. The system can also readily be used to assert tax deficiencies, if necessary, at the partner level. In such a rapidly changing area, we do not pretend to say that every last problem has been solved.

Indeed, we are currently involved in discussions with members of the investment community to ascertain whether procedures can be instituted to assure better handling of "street name" accounts. Nevertheless, our experience indicates that these problems are, if not entirely solved, entirely soluble. If further fine tuning is required, we are fully prepared to cooperate with this Committee and the Treasury Department to improve procedures.

It is my understanding that the Report based its proposal, in part, on a study of the American Law Institute ("ALI"), which appeared concerned about possible administrative problems arising from the public trading of partnership units. I wonder whether this proposal would have been forthcoming if the ALI had considered this question after TEFRA was enacted. For example, I understand that, after TEFRA became law, the ALI proposal was overwhelmingly rejected by the Section of Taxation of the American Bar Association. Based on our experience, the argument that the public trading of partnership interests leads to unmanageable administrative problems just does not hold water. It would, in my judgment, be a great mistake for the Committee to act precipitously as a consequence of possible misconceptions or biased views of a limited number of persons.

Mr. Chairman, I very much regret the characterization by Staff of the public trading of partnership interests as an "abuse." The Internal Revenue Service has joined us in recognizing there is nothing abusive with respect to the trading of partnership units. Apache is proud of a significant innovation within the law, the spirit of the law, and consonant with this nation's recognized need for reliable sources of energy to avoid energy blackmail, of jobs to avoid unemployment and the rising burden to every American at $200 million annual deficits, and of private capital investment to generate the work, revenues, and taxes to fund the costs of that debt. This abuse characterization only reduces the quality of public discussion about an important issue.

Supplemental Statement
of
Raymond Plank
Chairman and Chief Executive Officer
Apache Corporation
Relating to
October 24, 1983 Hearings before Committee on Finance,
United States Senate
on
The Reform and Simplification of the
Income Taxation of Corporations
November 2, 1983

This statement supplements the statement and oral testimony I gave to this Committee on October 24, 1983, concerning the recommendation contained in the staff report that publicly traded partnerships be taxed as corporations. During the course of my testimony, I was asked by Senator Danforth to explain the difference between being a partner in a partnership and a stockholder in a corporation. There are distinct differences between these two types of investments that reject the thesis that these investment options should be treated in the same manner for tax purposes. I would like to respond more fully to Senator Danforth's question by pointing out the substantial differences between shareholders and limited partners in this supplemental statement.

I am convinced that the conversion of corporations to limited partnerships will not induce a horde of new investors to participate in the "disincorporation of America" as implied in the Forbes article. As I indicated in my prepared statement, I would like to develop this rationale more fully. This supplemental statement responds to these two issues.

Differences Between Limited Partners and Stockholders

There are a number of significant reasons -- economic, legal, and tax -- that distinguish limited partnerships from corporations and limited partners from stockholders. These differences are so substantial that a businessman (or corporation) must carefully examine a wide range of options before he makes a decision to participate as a general partner in a limited partnership. Similarly, the investor is confronted with a number of economic, legal and tax questions that may significantly affect the results of his investment. Many of these reasons, when weighed overall, clearly lead to the decision to choose the corporate rather than the partnership form of doing business, or to invest in a corporation as a stockholder instead of in a partnership as a limited partner.

There are similarities in ownership of shares and partnership units such as equity ownership, issuance of certificates, trading, but beyond these areas the similarities end. The principal differences that I would emphasize include the following:

(1) A limited partner generally assumes significantly greater risks of possible unlimited liability arising out of the partnership business than a stockholder does with respect to corporate business. The risk of possible unlimited liability is a major disincentive attaching to business in the partnership form.

(2) The personal liability of a limited partner for partnership liabilities, both to creditors and to tax authorities, is significantly greater than those of corporate shareholders. Creditors generally have the right to seek return of capital distributed to a limited partner in payment of partnership liabilities that arose before such distribution. This right survives a partner's termination of his interest. Again, unlike corporate shareholders, limited partners may be liable for substantial future tax liabilities, also long after they have disposed of their interests.

(3) A major barrier to investment by a partner in a partnership is that a partner may be liable to pay tax on his share of the taxable income of the partnership, even though no cash is disbursed to him. This liability often arises where the partnership incurs substantial debt and partnership income is used to amortize principal. The potential exposure of limited partners to tax liability without having cash with which to pay the tax is a major disincentive to doing business in the partnership form of business and is widely so perceived in the investment community.

(4) Partners face certain other major tax disadvantages as compared to stockholders. Partners who sell their partnership units are, unlike corporate stockholders who sell their stock, liable to "recapture" of ordinary income that is attributable to certain deductions and credits previously taken by them (*e.g.*, accelerated depreciation, intangible drilling costs, investment tax credit, etc.), even in the absence of gain. If stock appreciates in value, the stockholder knows that his maximum tax will be a capital gains tax on his gain; on gain from sale of a partnership unit, the partner may face substantial ordinary income tax. A partner also faces possible

adverse, and unexpected, tax effects if the partnership is deemed, under IRC § 708, to terminate because more than 50 percent of the partners sell their interests in any year.

(5) A partnership is in most respects more complex and cumbersome to operate than a corporation particularly with respect to accounting for partners' share of income or loss. Therefore, the costs of doing business as a partnership are often much greater. These costs of doing business are economic, affect the pre-tax rate of return to investors and they clearly affect the investor's choice.

(6) Corporate law (particularly the law concerning the relationship between managers and investors) is well settled compared to partnership law. Each state has a comprehensive, constantly modernized corporation statute that regulates all significant aspects of the conduct of corporate affairs. The state partnership statutes, usually the Uniform Law or a variation thereof, are much less detailed. A number of unsettled legal questions exist in the partnership area concerning such matters as the extent of a partner's interest in partnership property, the right of an assignee to become a successor partner, the remedies of a partner for mismanagement by the general or managing partner, the rights of a partner to force a termination of the partnership, and similar problems. In particular, the notion of the fiduciary responsibility that is placed on a general partner is comparatively undeveloped under partnership law; for this reason, many businesses are loath to become general partners in large limited partnerships. In short, many businessmen and investors are unwilling to leave the safe haven of most aspects of corporate law for the undeveloped and uncertain aspects of partnership law.

Limited Partnerships Will Not "Disincorporate America"

The Forbes article created the impression that the attraction of publicly traded limited partnerships would lead to the "disincorporation" of America. Six points are to be made in response to this argument.

First, the tax advantages of the limited partnership arrangement are greatest for those lines of business that are characterized by a combination of current cash flow and special tax incentives in the form of substantially accelerated deductions and credits. Second, Congress has provided these special tax incentives to assure these businesses adequate capital to meet the goals which are consistent with national policy. Third, these incentives can only be availed of by investors through partnerships and, hence, these lines of business are already conducted in large part in partnership form.

Fourth, there may be very substantial tax costs to the disincorporation of existing businesses in the form of recapture and capital gains recognition. Fifth, legal and tax distinctions between partnerships and corporations result in real differences in business operations and in the financial risks and rewards incurring to investors, thus lessening the importance of the fact that partnerships pay no corporate tax. Sixth, the specter of revenue loss raised by the Forbes article is probably overstated and certainly premature. An important revenue drain has not been occurring and is unlikely to occur soon. Established companies will find it costly to disincorporate, while new companies, even if they choose the partnership form, will displace older ones very slowly. In the two- and-a- half years since Apache Petroleum began the reported trend to publicly traded partnerships, the total amount of business done in all fields by publicly traded partnerships is equivalent to a fraction of one percent of the oil production industry alone. Of more than 10,000 independent oil and gas companies, fewer than ten have organized publicly traded limited partnerships since the form was designed more than two years ago. This number would hardly constitute a "trend."

It must be emphasized again that the advantages of the partnership form coincide with those types of businesses that Congress has provided with special tax incentives because of their importance to the national interest. If energy and resource companies, for example, were required to pay taxes as corporations, much of the tax incentive intended for them would just accumulate as unused carryovers. Investment capital going into partnerships would not necessarily go into corporations. The same would happen for young, fast growing high-technology companies. Alternatively, if these companies are forced to operate as non-traded partnerships, the financing for such companies would continue to be restricted to a narrow class of investors. In either case, less capital would be available for research, oil exploration, mining and other vital resource production.

The most likely prospects for conversion from corporate to partnership form are corporations in the areas of mining, oil and gas production, forestry, and real estate. In 1980, the latest year for which data are available, corporations with their principal business activity in these industries accounted for less than 4 percent of total corporate income tax. These companies also accounted for only 7 percent of total net losses.

However, in those lines of business that lack the characteristics of accelerated deductions and cash flow, the disadvantages of the partnership form of doing business become material. The corporation, regardless of the corporate tax, is the preferred method of doing business in America. As the history of business has clearly demonstrated, most areas have not generally been attractive to partnerships. It is no accident that the natural resources, real estate, equipment and research areas have attracted hundreds of thousands of investors, and billions of dollars, into illiquid partnership investments, whereas other business areas have failed to do even a small part of that. There is no reason to suppose that addition of the single characteristic of liquidity for the partner/investor would, in these latter areas, significantly accelerate a tendency to favor the partnership over the corporation that has not otherwise even begun to appear.

Multinational corporations, in particular, would find the partnership alternative unattractive. Foreign shareholders could become liable for additional taxes because, as partners, they are individually deemed to be doing business in the United States. If the company has real estate interest, foreign partners, unlike foreign shareholders, would be subject to FIRPTA. Also, Federal law precludes the ownership by non-U.S. persons of certain Federal leases.

It has been reported, but as yet not fully confirmed, that conversion to a partnership may be attractive to corporations that have existing NOL carryovers and exhausted earnings and profits. If a legal means is found to "bail out" such companies through disincorporation, then it is important that these cases be differentiated from the resource/real estate companies with which I am concerned. A substantial move to disincorporate well known "loss companies" might truly present a concern for revenues, but that concern should be focused on the treatment of carryovers, not on the tradeability of interests.

As noted above, it is unlikely that existing corporations will make a wholesale move toward the partnership form. There remains the concern that newer companies will, as familiarity grows, choose the publicly traded partnership vehicle when they reach the stage of "going public." This alternative might be especially attractive for companies with good prospects, some current cash flow, and relatively large accelerated deductions and credits, such as those in the high-tech fields. But is Congress really ready to introduce tax impediments to the growth of such companies and thus reduce available capital for those industries they believed to be in the national interest to develop? In any event, if increasing use of the partnership format raises the prospect of substantial revenue loss, this issue should be addressed squarely and a determination made if, in fact, a revenue loss will occur. If so, the following considerations should be borne in mind.

Precipitous revenue loss cannot occur unless there is a substantial movement to disincorporate existing, large taxpaying corporations, or if disincorporation can be used to cash out large loss carryovers. To the extent that substantial recapture is a price of disincorporation, the near-term revenue loss is offset even in these unlikely cases. The concern that newer companies will go public in partnership, rather than corporate, form may be more realistic, but the resulting revenue effect would be a slow, long-term process. I am not convinced that, in the oil and gas area, the Treasury derives less tax from a revenue stream that flows from partnership to partner and back into the money system than it does from revenues that are generated by corporations. However, I have asked Apache's economists and analysts to develop a hypothetical comparison of the taxes paid by APC's unit holders and the taxes that would have been paid by them if the properties had been transferred to a corporation. I shall provide you with the results of this study.

Any revenue loss estimates promised on the process of new business formation would be very difficult and uncertain. Much new business is already done as partnerships or Sub-S corporations, so it would be necessary for those who claim revenue loss to estimate the "rate of disincorporation" by this process of attrition. At the least, a strong argument can be made that there is ample time to study this issue before it could become a real revenue problem. As noted, the extent of the current revenue loss must be miniscule, especially since most publicly traded partnerships were formed from partnerships, not corporations.

The final answer must be: we should not base sweeping tax changes that will have undeniably adverse effects on methods used by partnerships to raise capital today on uncertain and speculative fears about revenue loss tomorrow or on overly simplistic comparisons of different forms of doing business. In the long run, the publicly traded partnership will, I am convinced, greatly serve our national objectives by providing a more effective means of raising capital in those areas where, quite simply, capital has always been hard to obtain, and where the partnership form of doing business has historically been used. They will do so, as our experience has demonstrated, with no significant loss of revenue.

STATEMENT OF GEORGE S. SLOCUM, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, TRANSCO ENERGY CO., HOUSTON, TEX.

Mr. SLOCUM. I appreciate being able to represent Transco Energy Co., and its affiliated limited partnership, Transco Exploration Partnership.

We are opposed to your staff's recommendation that publicly traded limited partnerships be taxed as a corporation. The Forbes article apparently relied on so heavily by the staff would lead you to believe that the sole reason for establishing a publicly traded limited partnership is to avoid taxes. This is simply not true.

Transco changed the structure of its oil and gas activities for several more important reasons than that. It took this step primarily to focus market attention on the significant value we had in our substantial oil and gas investments by selling a direct minority interest in the partnership to the public.

In addition, the equity proceeds received from the sale of the partnership units and the potential to use newly issued units for tax free exchanges of properties significantly increased the partnership's financial flexibility to aggressively find and acquire oil and gas reserves.

The tax ramifications of this transaction were a secondary consideration to us. We still have almost 90 percent of the same tax position as we had previously and will have to account for our share of partnership tax items in our consolidated corporate tax returns.

Likewise, the public limited partners were, and hopefully will be, attracted to invest in Transco Exploration; primarily, because it offers an opportunity to own substantial oil and gas reserves on a ground floor basis. There is definitely no tax free lunch on this menu either since any savings associated with the elimination of the corporate tax bite are offset later at the time a unit holder sells his investment.

Contrary to the "Disincorporating America" theme of the Forbes article, it was not to avoid taxes but rather for the purpose of enhancing Transco's oil and gas investment and improving its capital raising flexibility that we entered into this partnership transaction.

Let me quickly sum up by saying that there are two further reasons why we would argue against the staff's recommendation. First, the fact that a limited partnership is publicly traded should not be the sole criterion for taxing it as a corporation. Current law and regulations have well established the criteria for determining when a business enterprise should be taxed as a corporation.

Second, the recommendation is a drastic departure from the well established principle of Federal income tax laws that the taxpayer should have the freedom to select among various forms of doing business.

If Congress decides for whatever strong policy considerations to extend the reach of corporate taxation to all partnerships, so be it. The staff's recommendation to apply corporate tax rules only to publicly traded partnerships, however, is without foundation. All partnership interests have some degree of marketability, and it seems to us patently unfair to isolate only those that have elected to list on an exchange.

Thank you.

[The prepared statement of George S. Slocum follows:]

HEARING ON REPORT ON REFORM OF CORPORATE TAXATION - OCTOBER 24, 1983

Testimony of Mr. George S. Slocum

Executive Vice President and Chief Financial Officer of Transco Energy Company

Introduction

This testimony is given on behalf of Transco Energy Company ("Transco"). Transco, with assets well in excess of $3 billion, is engaged through various subsidiaries in the operation of a major interstate gas pipeline system, in domestic oil and gas exploration and production and in other energy related activities. Shares of Transco common stock are traded on the New York Stock Exchange.

Transco is a general partner of Transco Exploration Partners, Ltd. ("TXP"), a Texas limited partnership, formed to succeed to the oil and gas exploration and production business being conducted by Transco Exploration Company ("TXC"), a wholly-owned subsidiary of Transco, primarily offshore Louisiana and Texas in the Gulf of Mexico. On July 13, 1983, TXC contributed all of its assets and business to TXP, and TXP assumed substantially all of TXC's liabilities, in exchange for interests in TXP. Immediately thereafter, limited partner interests in TXP were offered and sold to public investors in an underwritten primary offering. As a result, the public owns approximately 10% of TXP. TXC owns approximately 89% of the limited partner interests in TXP (interests in TXP were not distributed to stockholders of Transco) and TXC is the managing general partner of TXP. Based upon the current market value of limited partner interests in TXP (approximately $21 per unit), TXP has a market value in excess of $1 billion.

TXP was formed by Transco and TXC solely to attract capital for oil and gas exploration and development and to better demonstrate the value of Transco's activities (through TXC) in oil and gas exploration and production by creating an independent, publicly owned entity with unique investment characteristics. Limited partner interests in TXP owned by persons other than TXC are generally held by a depositary and are represented by depositary units. Such units are traded on the New York Stock Exchange.

Transco is opposed to the recommendation that a limited partnership with publicly traded partnership interests be treated as an association taxable as a corporation, which recommendation was made by the Staff of the Senate Finance Committee in its preliminary report on "Reform and Simplication of the Income Taxation of Corporations" released on September 22, 1983.

Policy Considerations

There are at least three substantial reasons for the opposition of Transco to the recommendation of the Staff. To begin with, the recommendation will have an adverse impact upon the ability of companies, particularly in the natural resource area, to effect capital formation. The publicly traded limited partnership is an innovative method of attracting capital to the energy industry, which capital is necessary to put the energy industry back to work and to achieve this Nation's goal of energy self-sufficiency. Partnerships have, traditionally, been utilized by the energy industry as a financing vehicle. The public trading of interests in such partnerships is, in effect, nothing more than an outgrowth of the desire for liquidity with respect to such venture financing. Obviously, such liquidity should not create a different Federal income tax result. The publicly traded partnership also taps a substantially unused source of capital for the energy industry--the investor of modest means. The publicly traded partnership provides to the small investor the opportunity to invest relatively small amounts of capital in the oil and gas business (as compared to most private offerings, which typically have large, minimum investment requirements) while retaining liquidity without additional cost (as compared to many registered offerings which provide liquidity but only at a substantial discount).

In addition, however, the recommendation is essentially inequitable with respect to existing publicly traded partnerships, such as TXP, and partnerships in formation. Such inequity is particularly unfortunate since publicly traded partnerships have typically spent, or are in the process of spending, significant sums in developing the necessary procedures to insure efficient operations which would comply with all applicable laws, including Federal income tax laws. That the Staff would make such an unfounded distinction between partnerships and other forms of business enterprises is disturbing. In light of the fact that TEFRA has mooted the concerns raised by the ALI with respect to the audit of partnerships, it seems clear that no longer can a distinction be made, as the ALI made, between a publicly traded partnership and other noncorporate, publicly traded entities. If neutrality requires anything, neutrality would require that all such publicly traded noncorporate entities, regardless of form, be treated alike.

It should also be noted, of course, that the logical reach of the recommendation is not clear. The "problems" raised by the Staff would seem to be prevalent not only in publicly traded partnerships but also in other publicly traded, noncorporate entities as well as large publicly registered (but untraded) partnerships. Thus, the Staff may have had in mind an ultimate extension of this treatment to other noncorporate entities (such as registered partnerships, royalty trusts, mutual funds or

REITs) when it cited, as support for its conclusion that publicly traded partnerships are large scale enterprises, the fact that there exist a substantial number of large, apparently registered partnerships the interests in which are not publicly traded.

Finally, the recommendation is simply inconsistent with recent administrative, legislative and executive policy. For example, although it has been suggested that the Internal Revenue Service has raised questions with respect to publicly traded partnerships, it is clear that the concern of the Internal Revenue Service is not with the trading in such units. Rather, the concern of the Internal Revenue Service has been expressed to be the relationship between certain nonrecognition provisions of the Code and certain collapsible partnership rules of the Code. The fact that the Internal Revenue Service has issued at least five rulings with respect to publicly traded partnerships confirms that conclusion. Also, notwithstanding such suggestion, Transco was advised that it could have obtained a ruling from the Internal Revenue Service with respect to TXP but it did not feel the need to do so because it was advised by counsel that the law is clear on this issue.

That the recommendation is not consistent with recent legislative action seems clear as well. Enacting the Subchapter S Revision Act, the Congress reconfirmed its determination to allow taxpayers to select various forms of doing business. In expanding the availability of the subchapter S, pass-through rules, Congress gave a clear signal that taxpayers should be given the opportunity to obtain pass through treatment with respect to business activities, even those conducted by certain corporate entities. The recommendation, obviously, would have the opposite effect.

Finally, the proposal is inconsistent with statements made by President Reagan with respect to the taxation of corporations in general. At a minimum, President Reagan's comments mean that corporate taxation should not be extended beyond its current reach (for example, to noncorporate entities such as publicly traded partnerships).

Basis of Staff Recommendation

Neutrality.

The Staff based its recommendation with respect to publicly traded limited partnerships on the "principal argument" of "neutrality: publicly traded limited partnerships are simply too similar to business entities that are taxed as corporations." Since it is apparently the Staff's view that publicly traded partnerships are very similar to corporations and that like entities should be taxed alike, the Staff concluded that limited partnerships which are publicly traded should be taxed as corporations. As evidence for its conclusion that limited partnerships with publicly traded interests are similar to corporations the Staff cited an article contained in the August 1, 1983 issue of Forbes. No other evidence was cited by the Staff.

Similarities Cited. The Forbes article listed a number of ways in which a publicly traded limited partnership appears similar to a corporation. The first point raised by the article was that a publicly traded limited partnership "reinvests about 50% of its income." No evidence was cited by Forbes, however, that corporations, in fact, reinvest about 50% of their income. Indeed, for that matter, no evidence was cited that publicly traded limited partnerships, in general, reinvest approximately 50% of their income, the statement made in the article being related solely to Apache Petroleum Company and its stated policy to reinvest approximately 50% of its income. TXC, as managing general partner of TXP, has stated that it intends to reinvest TXP revenue to the extent such reinvestment is consistent with its distribution policy and its intent to continue as an active participant in the oil and gas exploration and production business. TXP presently expects to reinvest substantially more than 50% of its revenue. Frankly, nothing appears magic about 50%. It seems clear that the reinvestment of income by either a partnership or a corporation depends not upon some stated percentage of revenue but rather is a function of business exigencies faced by such entity. Certainly, the magnitude of reinvestment is not indicative of either a corporate or partnership structure. Notably, taking into account Federal income taxes with respect to income and ignoring distributions (other than to defray taxes) or dividends, a corporation has a minimum of 54% of its net taxable income to reinvest (100% less 46%, the maximum rate of corporate tax) while a partnership (assuming a distribution is made to partners to defray Federal income tax liabilities equal to 50% of net taxable income) has available only 50% of its net taxable income to reinvest. Thus, the fact that a publicly traded limited partnership may seek to reinvest approximately 50% of its income would not seem to be indicative of anything other than the business judgment of the management of such entity.

The second item listed by the Forbes article which was deemed by it to be a similarity between a publicly traded limited partnership and a corporation was that a publicly traded partnership issues depositary units "(which are exactly like shares of stock, except for tax purposes)." Certainly, depositary units bear some likenesses to corporate stock. Both a depositary unit and a share of stock are represented by a certificate. Both are generally freely assignable. Both stock and depositary units can be held by a nominee for the account of a beneficial owner.

The similarities are substantially outnumbered, though, by the dissimilarities between the two. A depositary unit issued with respect to a publicly traded partnership represents an interest of a limited partner in that partnership. Stock represents an interest of a stockholder in a corporation. Under certain circumstances, a limited partner is liable to creditors of the partnership, unlike a corporate stockholder with respect to creditors of a corporation. For example, a limited partner is liable to creditors of the partnership for any amount, with interest, of his contribution which has been returned to him to the extent that it is necessary to discharge liabilities of the partnership to creditors who extended credit or whose claims arose before such return and for money or other property wrongfully paid or conveyed to him on account of his contribution. Also, a limited partner who takes part in control of the business of the partnership becomes liable as a general partner to the partnership -- giving rise to unlimited liability. In contrast, a stockholder of a corporation is, in general, not liable to creditors of that corporation.

Similarly, unlike a stockholder of a corporation, a limited partner, by statute, is entitled to certain information from the partnership including an accounting of partnership transactions and the right to inspect partnerships books without regard to a statutorily specified magnitude ownership. Further, a limited partner has a right to require the partnership books be kept at the principal place of business of the partnership, have on demand true and full information of all things affecting the partnership and have dissolution and winding-up by decree of court.

Also in contrast to the rights of a stockholder in a corporation, a limited partner has certain voting rights which are, in general, established by agreement and not by statute. For example, under TXP's limited partnership agreement, a simple majority-in-interest of the limited partners may vote to dissolve TXP, may remove the managing general partner of TXP, may preclude the sale of all or substantially all of TXP's assets and approve or disapprove of an amendment to the agreement. In contrast, most corporation statutes provide that such actions require the vote of a supermajority (usually 66 2/3%) of stockholders in many cases.

Perhaps the most significant feature which distinguishes corporate stock from a depositary unit are Federal and state laws which raise concerns with respect to the ownership of depositary units by non-residents or non-U.S. citizens. For example, Federal law precludes the ownership by non-U.S. citizens of certain Federal leases either directly or through a partnership. Accordingly, TXP units were not designed to be sold to non-U.S. citizens. Along the same line, under the TXP partnership agreement, if a risk of forfeiture of a Federal lease arises as a result of the nationality or other status of any holder of a depositary unit, TXP may redeem such unit. Such restraints, however, do not generally apply to ownership of stock of a corporation owning Federal leases.

Finally, not all interests in publicly traded limited partnerships are represented by depositary units. To begin with, depositary units are typically used only by those publicly traded partnerships whose units are traded on the New York Stock Exchange. More importantly, as earlier stated, depositary units represent interests in the partnership which are deposited with the depositary. Under the TXP agreement, any holder of a depositary unit may, however, withdraw from the depositary the partnership interests represented by the depositary unit. In such case, the interest in the partnership, upon withdrawal, is not tradable on the New York Stock Exchange and, in general, is non-transferable except upon death or operation of law, a rather significant restriction.

A third feature of publicly traded limited partnerships deemed similar to corporations by the Forbes article was the fact that publicly traded limited partnerships make "annual" distributions. (Most publicly traded partnerships make quarterly, not annual, distributions.) Such distributions are not required, however, and some publicly traded partnerships may not make any distributions at all. Although the reasoning of the writer of the Forbes article as to why annual distributions create a similarity between publicly traded partnerships and corporations is not apparent, it should be noted that the standards for a dividend and a distribution differ in material ways. Under most corporate statutes, the board of directors of a corporation has statutory duties to creditors with respect to dividends. In addition, of course, a corporation may be required by its certificate of incorporation or other organizational document to pay dividends to certain classes of stockholders in priority to others. Unlike the board of directors of a corporation, though, a general partner of a partnership has no statutory duties or fiduciary responsibilities to a creditor with respect to distributions. As was noted above, certain distributions when made must be returned by limited partners. Thus, the duty owed to creditors in the context of a limited partnership is that of the limited partners and not the general partner. Significantly, all entities, whether they be corporations, partnerships, royalty trusts, or others, engage in periodic distributions of funds. Distributions are, of course, nothing more than the vehicle by which owners of the enterprise participate in the successful operations of the enterprise. To point to such a factor as a similarity solely between partnerships and corporations is without foundation.

Another factor cited by the Forbes article bearing upon the similarity between a publicly traded limited partnership and a corporation is that a publicly traded limited partnership borrows money. Although borrowing money is a characteristic of virtually all forms of business enterprises (and, therefore, can hardly be relied upon as a similarity between only two forms) the borrowing of money by a partnership is subject to different restraints than are borrowings by corporations in many cases. Under state law, for example, loans to partnerships are often subject to more restrictive usury provisions. Also, as was mentioned earlier, borrowings by a partnership give rise to different liabilities to creditors by the owners of the enterprise depending upon whether the enterprise is a corporation or a partnership.

The last similarity cited by the Forbes article is that a publicly traded limited partnership may engage in acquisitions. Again, however, such activity is typical of many forms of business enterprises and should not be viewed as a factor which bears upon the similarity of only publicly traded partnerships and corporations. It should also be noted, though, that partnerships are seemingly not subject to state statutory take-over rules. Accordingly, the acquisition activity of a partnership may be conducted in a different environment from that of a corporation.

Dissimilarities. Even though the Forbes article listed a number of similarities between corporations and partnerships (which, on analysis as above, appear not to be significant similarities at all) the Forbes article failed to mention the numerous differences between a partnership and a corporation. For example, under Federal income tax laws a sale of stock in a corporation at a gain will, in general, give rise to capital gain. In contrast, the sale of a depositary unit will give rise to ordinary income to the extent that there is a recapture of certain deductions claimed by the partnership. Other differences include the following:

(1) A member of a partnership, the general partner (or general partners), has unlimited liability with respect to activities of the enterprise while no member of a corporation (stockholder) has unlimited liability.

(2) Limited partnerships are subject to state statutes which are materially different from state statutes to which corporations are subject.

(3) Although all states have relatively simple statutes providing for the qualification by a corporation to do business in such state, only a few states have a provision which allows for qualification of a limited partnership. In those states not having a qualification statute, a "new" partnership must be formed for such purpose raising difficult questions regarding limited liability, choice of laws and similar issues.

(4) The limited partnership is the traditional vehicle for capital formation and venture financing in certain industries which typically do not use corporations for such purposes.

(5) In order to preserve limited liability to limited partners in a publicly traded limited partnership, periodic state filings of the names of such limited partners must be made a corporation has no such requirement in order to preserve the limited liability of a stockholder.

(6) The bankruptcy of either the enterprise or a member of the enterprise works a dissolution of a partnership while such is not the case for a corporation.

(7) Typically, in its organizational document a limited partnership has an established term (sometimes a relatively long period) while a corporation is generally formed in perpetuity.

(8) By operation of state law, a general partner is the agent of all limited partners, (often times by agreement also possessing a power of attorney to act on behalf of the limited

partners with respect to state filings and related matters), while no stockholder is the agent of any other stockholder by operation of law.

(9) The withdrawal of the general partner of a partnership causes a dissolution of such partnership while the withdrawal of the board of directors, management or stockholder of a corporation does not affect the continuity of such corporation.

The Staff's comparison of a publicly traded limited partnership to a corporation can, in substance, be likened to the comparison of a basketball and an orange. Based upon a superficial analysis, and from a considerable distance, an orange and a basketball appear similar in color, texture and shape. A more rigorous analysis of a basketball and an orange, like the analysis of corporations and partnerships contained above, shows that there are more dissimilarities than similiarities between the objects being compared, however.

Development of Legal Criteria. Despite the unsuccessful efforts of Forbes to describe similiarities between a corporation and a publicly traded limited partnership, the courts and the Internal Revenue Service have for some time had no difficulty in differentiating between the two. From the outset, of course, Federal income tax laws have applied to corporations. Although the term corporation has not been defined in detail by statute, the Revenue Acts of 1917, 1921, 1924, 1926 and 1928 contained language substantially to the effect that the definition of corporation includes an association. In 1935, the United States Supreme Court focused on the definition of association and identified, for the first time, the factors which should be looked to in distinguishing between corporations and other business enterprises.

Basically, that decision, *Morrissey v. Commissioner*, 296 U.S. 344, 56 S. Ct. 289 (1935), established the four criteria to be free transferability, continuity of life, limited liability and centralization of management. Thus, transferability of interest was a factor but, significantly, far from being the only factor mentioned. In fact, it not only was only one of a number of factors mentioned by *Morrissey*, it was given *less* emphasis by the court than the others. The 1934 and 1954 Revenue Acts contain similar provisions to those contained in the earlier acts.

The applicable Treasury regulations promulgated under Section 7701 of the Internal Revenue Code (the "Code"), primarily in response to the decision rendered by the 9th Circuit in *United States v. Kintner*, 216 F. 2d 418 (9th Cir. 1954), lists the same four factors in distinguishing between a partnership and a corporation. Under the regulations, where a partnership has a preponderance of these factors, such partnership will be treated as an association taxable as a corporation.

Significantly, the Treasury Department issued in 1979 a revenue ruling which listed a number of factors which are, in effect, subsumed into the four listed major characteristics. Among those factors listed (and subsumed) were the division of limited partnership interests into *units or shares* and the promotion *and marketing* of such interests in a fashion similar to stock in a corporation. Accordingly, the Internal Revenue Service has ruled, on at least five occasions, that a publicly traded limited partnership will be treated as a partnership and not as a corporation for Federal income tax purposes.

Consequently, it appears that the Internal Revenue Service is unconcerned about the public trading of limited partnerships while the Staff has singled out such activity as the sole criterion on which the association-partnership issue should be decided when dealing with publicly traded limited partnerships. Almost as if to emphasize the differences between the Internal Revenue Service and the Staff, the Internal Revenue Service announced early in 1983 that it was undertaking a study to determine whether a different factor (limited liability) should be singled out as a determinative factor in connection with the association-partnership issue. Interestingly, the Staff apparently views the public trading of interests to be irrelevant when applied to other noncorporate enterprises such as royalty trusts, mutual funds or REITs, though.

Administrative Problems

Also raised by the Staff as an argument favoring its recommendation is the fact that "substantial questions" have been raised whether partnership tax rules can work with respect to publicly traded limited partnerships. The Staff cited a recommendation by the American Law Institute ("ALI") as supporting its view that the partnership tax rules may not be workable as to such entities. The ALI did recommend that any publicly traded limited partnership be treated as a corporation but the recommendation was made primarily because of perceived audit problems caused by such entities. The recommendation, however, was made in 1981 prior to the passage of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). The ALI did note, too, that even if the audit problems were solved, the pass-through treatment for publicly traded entities "has been the subject of intensive debate over the last ten years." Cited in a footnote to the ALI recommendation were a number of issues raised by Charles E. McLure in his book "Must Corporate Income Be Taxed Twice?" (Brookings, 1979). (Mr. McLure, of course, was recently appointed Deputy Assistant Secretary for Tax Policy.) Those issues raised were statute of limitation difficulties, collection problems, treatment of certain pass-through items and allocations of income for trades made during the year.

As noted, though, the ALI recommendation was made prior to the enactment of TEFRA. Included in TEFRA were two provisions designed primarily to solve the audit problems raised by the ALI. To begin with, TEFRA contained provisions for partnership level audits which should eliminate most, if not all, questions concerning the audit of partnerships. Given the opportunity, it seems clear that in the age of the computer and advanced record keeping technology the Internal Revenue Service and the Treasury Department, along with representatives from the publicly traded limited partnerships, will be able to develop procedures to insure that the partnership level audit provisions of TEFRA will obtain the intended result of simplifying (perhaps even streamlining) partnership audits. The second provision of TEFRA that would seem to bear on the audit issue is the requirement that a partner report partnership tax items consistently with the treatment of such items on the partnership's tax return unless the partner files a statement with his return identifying any inconsistency. Accordingly, the provisions of TEFRA have, in large measure, mooted the concern expressed by the ALI in making its recommendation to treat publicly traded partnerships as corporations.

The ALI also noted, however, that even if the audit problem could be surmounted the issue of pass-through treatment for publicly traded entities "has been the subject of intensive debate over the last ten years." Notably, the ALI did not indicate that there was a consensus supporting treatment of public traded entities as corporations, rather only that the issue had been raised and debated. The Staff did cite, in a footnote, several issues that had been raised in such debate with respect to publicly traded entities. In particular, the footnote raised questions concerning statute of limitations and keeping returns open and the collection process in the event that an audit adjustment is made at the partnership level. Notably, TEFRA, in addition to providing for partnership level audits, provided a mechanism for a designated partner to keep the returns of all partners in the partnership open for purposes of adjustments arising out of an audit at the partnership level. It follows that the concern raised with respect to statute of limitations difficulties has also been mooted by TEFRA.

While TEFRA did not resolve any questions with respect to collections from large numbers of owners resulting from audit adjustments, this problem is certainly not peculiar to partnerships. For example, return of capital dividends of publicly traded corporations give rise to similar collection problems when the Internal Revenue Service adjusts the taxable income of the payor corporation such that the dividend is taxable to the stockholders (as in the case of many utility companies or companies engaged in the oil and gas business). Likewise, acquisitive reorganizations between publicly traded corporations can result in similar collection problems (as in the case of the ITT-Hartford transaction). It should be noted, of course, that there is no evidence of a problem with respect to collections from partners. Indeed, in the introduction and summary to the report, the Staff noted that compliance is greater at the individual level than it is at the corporate level.

Also cited in the ALI footnote were problems with respect to foreign tax credits and interest deduction issues arising from the treatment by a partner of pass-through items. Although the problem being raised with respect to these matters is somewhat unclear, it is clear that no compliance issue with respect to these factors was raised, again by reference to the Staff's own report. More specifically, the items were raised as a result of a discussion of such issues by Mr. McLure in his cited treatise. In the treatise, however, the topic for discussion was whether corporations which were publicly traded could be treated as pass-through entities for purposes of the integration of the corporate and stockholder income tax. Much of Mr. McLure's treatment of these items and the concerns raised, therefore, are predicated upon the additional complexity that would result from applying restraints to pass-through corporations fashioned by reference to the restraints now applicable to partnerships. The McLure treatise was not addressing, specifically, the advisability or even the practicality of continuing to allow pass-through treatment for publicly traded partnerships, already subject to the partnership provisions of the Internal Revenue Code. The McLure treatise does not appear to deal with the issue being addressed here.

Finally, the footnote raised a question with respect to allocations of income among owners who trade interests during the same taxable year. Again, these issues were seemingly raised with respect to treating a corporation as a pass-through entity rather than the issue whether a publicly traded partnership should be treated as a corporation. Notably, Section 706 of the Code provides rules for allocating income as between partners who are partners for less than the full taxable year, rules which have been detailed in regulations promulgated by the Treasury. There appear to be no allocation difficulties raised by the ALI in the pure partnership context and, if problems were to arise, such problems can easily be dealt with by strengthening the provisions of Section 706 of the Code (rather than departing so dramatically from existing law). (It should be noted, of course, that publicly traded partnerships rarely have special allocations which give rise to the "tax abuse" often focused on by the Internal Revenue Service and recently dealt with in the complex proposed regulations under Section 704 of the Code).

Additional Concern

Although not expressly stated by the Staff, another concern alluded to was the use of the publicly traded partnership to "disincorporate" large, industrial or manufacturing enterprises--"the GM factor". That such concern is unfounded is best evidenced by the absence of such use. To date, the publicly traded partnership appears to be attractive only to those industries in which partnerships have been historically used for capital formation. The problems with operating a large, industrial or manufacturing concern in partnership form, particularly in light of the differences between partnerships and corporations discussed above, appear overwhelming. The phrase multinational limited partnership is almost a contradiction in terms.

It should also be noted that current tax laws are such that it would be impractical, except for a handful of companies, to dissolve to operate in partnership form. The tax cost to either the corporation or the stockholders is simply too high. The other recommendations with respect to changes in corporate tax laws will, if adopted, add additional tax cost to such process.

Finally, there appears to be no reason for the Staff to characterize as an abuse a publicly traded limited partnership. Because of size, visability and the disclosure and reporting requirements, a publicly traded limited partnership appears to be less susceptible of abuse than many other entities. Indeed, to the extent that publicly traded partnerships are characterized (or perceived) as tax shelters, they attract tax shelter dollars which might otherwise be invested in nonpublic entities which may be prone to abuse.

From all of this, it can be readily seen that the Staff does not have a strong rationale for its recommendation. Indeed, there appears to be no such rationale. Presumably for this reason, the American Bar Association Section of Taxation has rejected this recommendation.

Conclusion

In conclusion, the recommendation of the Staff should not be accepted for a multitude of reasons. Most importantly, Transco believes the recommendation should not be adopted because the recommendation impinges upon the ability of the energy industry to effect capital formation at a time when the industry most needs such capital, the recommendation may have the effect of precluding modest investors from participating in the oil and gas business through the partnership form, the recommendation is inequitable to existing and future partnerships and the recommendation is inconsistent with recent administrative, legislative and executive actions. In addition, though, the Staff was unable to cite sound and convincing reasons to support the recommendation. The principal argument on behalf of the recommendation, neutrality, does not withstand analysis since to apply such doctrine one must conclude that a publicly traded partnership is, in fact, similar to a corporation. It certainly falls short of the mark to cite as authority a non-technical magazine article written for laymen. On analysis, there are more dissimilarities between a publicly traded limited partnership and a corporation than there are similarities. Thus, the doctrine of neutrality would require, instead, that partnerships be treated in the same fashion as other publicly traded, noncorporate entities. The secondary argument raised by the Staff in support of its recommendation, audit problems and other administrative difficulties, have been largely mooted by TEFRA. TEFRA seemingly addressed the problems raised with respect to partnership audits whether such partnerships be publicly traded or otherwise, as well as any statute of limitations problems. Other concerns, which appear to be relatively insignificant, are either not peculiar to partnerships or existing partnership provisions can be utilized to deal with any specific problems which might be later identified. Finally, there is little evidence on which to base a concern that the publicly traded partnership will result in the discontinuing use of the corporate form for large industrial or manufacturing enterprises. In sum, to single out the public trading of interests as the sole criterion on which to change the fundamental Federal income tax treatment of publicly traded partnerships is ill advised and without foundation. Thank you.

STATEMENT OF LEWIS H. SANDLER, GENERAL PARTNER, SOUTHWEST REALTY, LTD., DALLAS, TEX.

Senator DANFORTH. Mr. Sandler.

Mr. SANDLER. My name is Lewis Sandler. I'm a general partner of Southwest Realty, Ltd. It's a limited partnership which is engaged in ownership and acquisition, and development primarily of multifamily housing.

Our partnership was formed as a result of an exchange. It was not formed with the idea of avoiding taxes. In fact, many of the investors that were in our partnerships were partners in the old partnerships for up to 10 years.

The staff report talks about and discusses the concept of neutrality, which implies impartiality and evenhandedness. And we believe that impartiality would require that you tax all partnerships the same way. We also point out that the vast majority of corporations are privately held, and yet there is no suggestion that privately held partnerships be taxed as privately held corporations. We don't believe that the proposal is neutral. We feel that the proposal is a radical departure from existing, and established tax, and court criteria. And when making a radical departure like that, we believe that a great deal of study is required.

We would also like to point out that the very nature of this proposal has adversely affected the marketability of our limited partnership interests, and we would urge that the report delete at this time its proposal to tax publicly traded partnerships as corporations, and assign it to further study.

We thank you for the opportunity to be here.

[The prepared statement of Lewis H. Sandler follows:]

Hearing Scheduled for
October 24, 1983

October 18, 1983

United States Senate
Committee on Finance
Room SD-219, Dirksen Senate Office Building
Washington, D.C. 20510

STATEMENT ON THE REPORT ON REFORM OF CORPORATE TAXATION

Gentlemen:

This statement is submitted to the Senate Finance Committee in connection with its hearing on the Report and Simplification of the Income Taxation of Corporations and specifically in opposition to the question raised by Senator Dole concerning whether or not "inactive limited partnerships with publicly traded partnership interests (should) be taxed as corporations?"

This statement is submitted by and on behalf of Southwest Realty, Ltd. ("SRL") a publicly traded limited partnership engaged in the acquisition, ownership and operation of income-producing real estate, its general partners and its investors, past, present and future.

SRL was created as a result of an exchange offer made by SRL to the limited partners of 23 limited partnerships in which SRL's general partners (three individuals and their corporate affiliate) were the general partners. The exchanging limited partners acquired their partnership interests in SRL in exchange for their partnership interests in their predecessor partnerships. Pursuant to a private ruling received from the Internal Revenue Service, SRL will be treated as a partnership rather than as an association taxable as a corporation. The ruling further stated that holders of SRL's depositary receipts (evidencing the economic attributes of SRL's limited partnership interests) will be treated as partners for federal income tax purposes.

In reliance on this ruling, hundreds of investors exchanged their partnership interests for interests in SRL. It would be a gross inequity to these investors, some of whom have held their limited partnership interests for up to 10 years, to convert, by federal legislation, the tax aspects of their state-chartered limited partnership interests. The effects of such conversion would be potentially devastating to these investors and to SRL.

Subsequent to the consummation of SRL's exchange offer, hundreds of new investors have acquired limited partnership interests in SRL. Such acquisitions have also been in reliance on the private rulings of the Internal Revenue Service. Similar inequities will be suffered by such limited partners if their partnership interests are converted by the proposed legislation into the equivalent of corporate stock.

The very threat of this proposal may have deleterious effects on the market price of all publicly traded limited partnerships, including but not limited to SRL. The uncertainty overhanging the trading markets in partnership interests warrants the prompt attention to and dismissal by the Finance Committee of this preliminary proposal by its staff to treat publicly traded limited partnerships as corporations for federal income tax purposes.

If there are loopholes in the current law, we support their correction. If the current law harbors unintended hardships, we endorse suggestions that will effectively alleviate or eliminate such hardships. We do not believe, however, that the preliminary report of the staff of the Finance Committee to tax publicly traded limited partnerships will plug any loopholes; it may, however, give rise to additional, albeit unintended, hardships.

One of the principal arguments in favor of the Committee's proposal is one of neutrality. It is alleged that publicly traded limited partnerships are too similar to business entities that are taxed as corporations. There are statutory as well as real differences between partnerships and corporations. The Internal Revenue Service recognized such substantive differences when it issued private rulings to SRL and at least 5 other publicly traded limited partnerships (Apache Petroleum Company, May Energy Partners, Ltd., Newhall Investment Properties, Newhall Resources and Petroleum Investors, Ltd.). These partnerships and others have relied on rulings issued by the Internal Revenue Service. At the very least, neutrality and fairness require treatment of these existing partnerships and any new and additional partners in the manner already approved by the Internal Revenue Service.

The concept of neutrality, however, raises several questions. Why not tax all partnerships as corporations? Is it size that is offensive? If so, what about the billions of dollars raised each year by the publicly syndicated partnerships, many of which have thousands of partners. In fact, many of these partnerships each have thousands of partners more than do some of the publicly traded partnerships. Why not tax the royalty trusts, the real estate investment trusts and other publicly trading unincorporated entities as corporations? In fact, why not tax all publicly traded entities as corporations regardless of size, number of investors, statutory authority or consequences? Neutrality would also require private partnerships to be taxed as privately held corporations. It would appear that the Committee's concept of neutrality is somewhat incomplete. The definition of neutrality would imply impartiality, even-handedness and possibly even fairness. These factors are all lacking in the Committee's approach to neutrality.

The concept of neutrality might also warrant the tax treatment of Subchapter S corporations as corporations. If size is the criteria, there are a number of Subchapter S corporations each of which controls billions of dollars of assets. Treasury, however, has recently seen fit to expand rather than contract the number of entities that qualify for Subchapter S treatment.-

Neutrality would also dictate a similar tax treatment for all partnerships. There is nothing magic about publicly-traded partnerships. If an entity is organized under the laws of a state as a limited partnership, it is a partnership regardless of whether or not its partnership interests are transferable or traded.

There is no justification under the law for treating a publicly-traded entity any different than any other entity created under the same statute. SRL was formed under the Texas Uniform Limited Partnership Act. So too were its predecessor partnerships that have in effect merged into SRL as a result of the exchange offer. The preliminary report of the staff of the Senate Finance Committee would have the effect of substituting free transferability as the sole criteria for taxation of an association as a corporation in lieu of the four criteria heretofore established by the Internal Revenue Service and the courts for such treatment.

Generally, such a radical departure from established rules and procedures would be preceded by in-depth studies and careful deliberation. Even then, drastic changes are generally adopted only where there are compelling reasons to do so. We have neither seen nor heard of any compelling reasons to tax any partnerships, let alone, publicly traded ones, as corporations. In fact, the issuance by the Internal Revenue Service, within the past two years of a number of private rulings to the effect that certain of the publicly traded partnerships would be treated as partnerships for the purposes, would suggest that the Internal Revenue Service is not aware of any compelling reasons to treat publicly traded partnerships any differently than other, non-trading partnerships. We believe that the preliminary report of the Finance Committee staff regarding publicly traded partnerships suffers somewhat from a lack of consistency and careful analysis.

Free transferability, in and of itself, is not dispositive of the question of taxability. Many partnerships provide for the free transferability of their partnership interests. In fact, to qualify for investment under ERISSA, partnerships are required to provide for such free transferability. Such partnerships are no different, in concept, purpose or operation, than are those whose interests are not only freely transferable but are also trading. Neither the law nor logic dictate a different tax treatment between partnerships whose interests are tradable and may be trading on a limited basis from those whose interests are trading on an active basis.

The Finance Committee staff has also questioned whether partnership tax rules work effectively for publicly traded limited partnerships. We are not aware of any partnership tax rules that will not work effectively for publicly traded limited partnerships. In the event and to the extent that any problems of administration arise, they can be dealt with on a specific basis. The burden, if any, in administering partnership tax rules has been placed on the partnerships and not on the Internal Revenue Service. This burden does not shift merely because a partnership is publicly traded.

In any taxable period, there are a finite number of investors in a publicly traded partnership. In many instances, such number will be less than the number of investors in a large publicly syndicated partnership. The reporting of taxable income, gain or loss and the dissemination of such information to investors has been effectively handled by publicly traded real estate investment trusts, utilities and royalty trusts for years. The tax rules for administering partnerships, publicly traded or syndicated, are no more complicated or difficult than those applicable to these other forms of business entities.

The administration of partnership tax rules has been an issue for years. Congress has dealt with the size and administration of partnerships under the recently enacted provisions of TEFRA. As a result, we now have centralized audits and procedures. The Internal Revenue Service and the Treasury Department appear to be satisfied that potential administrative problems relating to partnerships tax rules have been addressed and, for the most part, have been resolved.

We understand that the Senate Finance Committee is also considering a requirement for reporting so-called "burned out" shelters and that brokers maintain a list of their investors in limited partnership. These considerations are apparently in response to specific problems. We support these and other proposals that address specific problems with meaningful and consistently applied legislative remedies. We do not believe, however, that the staff's preliminary report identifies any specific problems or that the report applies meaningful or cosistent or uniform treatment to partnerships.

Southwest Realty was conceived and formed as a growth vehicle. It has the ability to raise equity and/or debt from either the public markets or from private placements. It was designed with maximum flexibility to draw from such markets in order to maximize its ability to raise new funds at the lowest possible cost. Clearly, if the proposed legislation is adopted, our ability to issue additional partnership interests will be severely hampered, if not curtailed.

Without the availability of new funds from time to time, SRL will find it difficult, if not impossible, to acquire or develop new income producing real estate properties. Since most of our portfolio is comprised of multi-family, rental housing projects, our ability to provide new rental housing will be severely impaired. In fact, the mere threat of the proposed legislation has contributed to the deferral of an offering that was on the verge of being filed. Such offering would have been the cornerstone for our development and/or acquisition of new multi-family rental housing projects. The form of a publicly traded limited partnership is well suited to encourage further development of multi-family rental housing projects by SRL and others. We believe that the staff's preliminary report will stiffle and discourage such development throughout the United States.

Who are our prospective investors? Are they the affluent who are seeking highly leveraged, tax sheltered investments in order to avoid or defer the payment of taxes? Our Partnership has a portfolio of existing income-producing properties in connection with which we are currently distributing on an annualized basis $1.20 per depositary receipt. Our investors are not seeking or receiving from SRL tax losses against which they can shelter income from other sources. In fact, SRL anticipates that an amount equal to approximately 50% of its distributions for 1983 will be taxable. Generally, we believe that our investors are seeking a reasonable return on investment and a hedge against inflation.

The Finance Committee report indicates that the proper classification of various types of business entities has been a continuing source of controversy and uncertainty in the tax law. It further indicates that the only relevant abuse examined by the staff has been the recent proliferation of publicly traded limited partnerships. We are uncertain as to what abuse the staff is referring.

We are under the impression that limited partnerships, publicly traded and otherwise have been created under state law and, as such, are legal entities. The creation of publicly traded partnerships is not, in and of itself, an abuse of any natural or tax laws. Our investors, contrary to the staff's opinion, have not invested, at least through SRL, in large scale tax-exempt business enterprises. The report refers to some 676 partnerships which, in 1980, each had more than 1,000 partners. In fact, there are currently fewer than two dozen publicly traded limited partnerships. We would hardly describe this as a proliferation. The high cost of formation and tax consequences will probably discourage any true proliferation of publicly traded partnerships.

We urge the Committee to withdraw its proposal to tax publicly traded partnerships as corporations. We respectfully request that such action be taken forthwith to remove any clouds that may have been inadvertently created over the trading of limited partnership interests. We thank the Committee for its early consideration of this matter.

Respectfully submitted by,
SOUTHWEST REALTY, LTD.

By: Lewis H. Sandler
Lewis H. Sandler
General Partner

STATEMENT OF ROBERT McDERMOTT, ESQ., ON BEHALF OF THE TIMBER REALIZATION CO.

Mr. McDermott. Senator Danforth, my name is Robert McDermott. I'm a lawyer from Chicago, and counsel for Timber Realization Co. I'm substituting for Warren Hood who couldn't be here at the last minute.

My testimony may be unnecessary if I understand the chairman's preliminary comments correctly. But I would like to focus on just one sole aspect of the classification proposal and that is the inequity of changing rules for existing limited partnerships, even as respects their future operation.

Timber Realization Co. was formed in a taxable transaction not to run a business like General Motors but to liquidate specific timberland assets. We and our partners paid at least $25 or $30 million in taxes, just last year and this, for the very purpose of changing, in reliance on existing law, from corporate status to partnership status. Please don't revert us back to corporate status at this point.

And if you grandfather us, please don't give us a limited calendar period of time in which to finish our operation.

Our partners don't want the general liabilities—general partners don't want the general liability that they now have any longer than they have to have it. We are liquidating just as fast as we can. We have already made great progress. We can't tell how long the last part will take. Please don't force us into a forced sale or fire sale.

Thank you.

Senator Danforth. Thank you, sir.

[The prepared statement of Warren A. Hood follows:]

Testimony of Warren A. Hood

I am one of the three individual general partners of AFH Partners, which is the general partner of Timber Realization Company, a Mississippi limited partnership.

Timber Realization Company is directly affected by the proposal in the Finance Committee Staff preliminary report of September 22, 1983, which would tax publicly traded limited partnerships as if they were corporations. We strongly oppose that proposal.

Timber Realization Company ("TRC") was created in August 1982 by Masonite Corporation. At that time Masonite transferred all of its woodland properties (consisting of timberland and related sawmills) to TRC and distributed all of TRC's partnership Units pro rata among the roughly 10,000 shareholders of Masonite. The distribution was a taxable partial liquidation for federal income tax purposes.

The purpose of the transaction was to provide a vehicle for the orderly liquidation of the woodland properties. The Partnership agreement requires us to proceed expeditiously to dispose of Partnership assets, satisfy or provide for its liabilities, and distribute the net proceeds of liquidation to our partners (Unitholders). We hope to complete this process within 5 years, but we aren't yet able to say whether this will be feasible. Our timberland holdings are substantial, and there are relatively few buyers, especially for our properties in California. If we can't wind up our liquidation within 5 years, the Partnership agreement permits us to go on longer with the approval of the holders of two-thirds of our Units.

I

Application to Timber Realization Company. We submit that TRC should not be affected by any change in the classification of limited partnerships, for several reasons:

First, the liquidation involved a heavy tax cost. The Partnership Units had a total trading value at the time of distribution of more than $247,000,000. While we do not have exact shareholder basis information, we believe that half or more of that amount represents realized capital gain, producing a likely capital gains tax in the range of at least $20 to $25 million. In addition, another $6.4 million of depreciation and investment credit recapture taxes were triggered by the liquidation.

If Congress reclassifies TRC as a corporation for tax purposes, it will virtually restore us to the tax status that Masonite had, notwithstanding the $25 or $30 million or more which have been paid in taxes, in reliance on existing law, to put us in the position of a limited partnership.

In addition, our Partnership Units have been traded over the past 14 months on the Philadelphia Stock Exchange and in the over-the-counter market. Reports indicate that more than 3.5 million Units have traded to date. The purchasers of these Units cannot have foreseen the adoption of the staff proposal when they made their investments.

Finally, Masonite Corporation, a large public corporation, was radically restructured by the creation of Timber Realization Company. Far the greater part of Masonite's previous assets are now in TRC, dedicated for sale in the liquidation of the Partnership. This too was done in reliance on preexisting law.

II

The Form of the Grandfather Clause. The simplest and fairest answer would be to grandfather all existing limited partnerships. Our impression is that there are only a relatively small number of public entities which are organized as limited partnerships. As a second alternative, we suggest that you adopt the same approach which was used when a somewhat similar partnership reclassification proposal was considered in 1978; namely, that the new law should not apply to existing limited partnerships unless they attempt to grow by acquiring new capital.

Other solutions are possible, but we think that they may be less easy to administer, and that their complications are unnecessary. We cannot support a simple deferment of the effective date simply because we cannot tell how long it may take to dispose of our properties, particularly in the West. There are only a few potential buyers of large timberland tracts in California; please don't drive us into a forced sale.

III

Should Any Limited Partnerships be Taxed as Corporations? We understand that other witnesses plan to testify on this matter in detail.

However, it seems clear that there has been no widespread rush by industrial organizations to disincorporate, that many existing limited partnerships have been created to serve limited and specialized purposes (to liquidate assets, in the case of TRC) and that, as I can myself attest, the personal liability of an individual general partner with responsibility for the operation of a large limited partnership provides a very significant distinction between that method of organization and that of a conventional corporation. Also, it seems anomalous to treat publicly traded limited partnerships as corporations while preserving partnership status for large partnerships which are not publicly traded, or for publicly traded trusts.

I thank you for the opportunity to appear before the Committee.

Senator Danforth. Mr. Plank, how many limited partners are there in the Apache Corp.? The Apache Corp. is a partnership?

Mr. Plank. There are actually two entities—the limited partnership and the corporation. The corporation has around 20,000 shareholders. At last count, there were somewhere around 15,000 or 20,000 in AFC, the publicly traded partnership.

Senator Danforth. 15,000 to 20,000 limited partners. And are they called shares?

Mr. Plank. No; they are called units.

Senator Danforth. And the partnership units are traded on the New York Stock Exchange?

Mr. Plank. Yes, they are.

Senator Danforth. If I wanted tomorrow to become a limited partner, I could call up my stockbroker and buy a partnership unit?

Mr. Plank. That is correct.

Senator Danforth. What would be the assets of the partnership?

Mr. Plank. The assets of the partnership would be oil and gas properties previously largely owned by individuals who had explored for oil and gas——

Senator Danforth. What would be the valuation?

Mr. Plank. The market valuation is around $600 to $700 million.

Senator Danforth. And, Mr. Slocum, how about the Transco Energy Co.? How many partnerships of Transco? How many partners rather?

Mr. Slocum. I understand the question. Are they the same set of questions you were asking Mr. Plank?

Senator Danforth. Right.

Mr. Slocum. We have approximately 51 million partnership units in total. However, 90 percent of those were retained by Transco Energy and its corporate subsidiary as cogeneral and limited partners.

The publicly held units total about 6 million, and right now, frankly, it's too early to tell in the flow-through process from the brokers to the individual holders just how many owners there are. I would guess they are probably going to end up going from 2,000 now to perhaps 2 to 3 times that amount when the 2 biggest retail-related underwriters distribute on through to their clients the amount of units purchased on the public offering.

Senator Danforth. How would I buy the units if I wanted to buy some?

Mr. Slocum. You would generally take the same procedure you did with Apache. Go a little further down the alphabet and call up your broker and ask for Transco.

Senator Danforth. That's publicly traded?

Mr. Slocum. Publicly traded. That's just approximately 6 million units that are owned by the public. The rest, as I said, continue to be held and not available to the public.

Senator Danforth. Are the units bought and sold on the New York Stock Exchange?

Mr. Slocum. That's correct.

Senator Danforth. Mr. Sandler, how about Southwest Realty.

Mr. Sandler. I think we have just under 1,000 holders at the moment. We have a registration statement ready to be filed that would more than double the number of holders. We are traded over-the-counter and on the Pacific Exchange.

Senator **Danforth**. What would be the assets of dollar amount of Southwest Realty?

Mr. **Sandler**. About $30 million.

Senator **Danforth**. And how about of Transco?

Mr. **Slocum**. The market provides of our publicly held units would be approximately $120 million.

Senator **Danforth**. Mr. McDermott, how about the situation at AFH?

Mr. **McDermott**. Timber Realization Co., AFH Partners, has about 10,000 unit holders whose units can be bought and sold on the Philadelphia Exchange. They were distributed pro rata to all of the shareholders of Masonite Corp. last year when Masonite transferred all of its timberlands to this entity in order to liquidate. And they have a present trading value of about $360 million. That should be substantially reduced as we make liquidating distributions as early as the first part of next year.

Senator **Danforth**. Now when partnership units are sold, are they registered with the SEC the same way that a public sale of stock is registered?

Mr. **McDermott**. Sir?

Senator **Danforth**. As far as the partner himself is concerned what is the difference between being a partner and being a stockholder in a corporation?

Mr. **Plank**. Well, the difference to the partner is that having held, in our instance, an interest in an illiquid partnership he now obtains marketability or liquidity for his investments at a time that an appraisal is made of his interest. As a result, No. 1, he does not have to pay a tax on the tax-free exchange. No. 2, the return that he gets upon his investment is not impaired by a second layer of tax.

Senator **Danforth**. Right.

Mr. **Plank**. Therefore, he gains liquidity and is not compelled to pay a 46-percent income tax rate which has the effect of discounting the true underlying value of his earning power by 46 percent. But is not disincorporating America.

Senator **Danforth**. Other than the tax consequences, what is the difference as far as the unit holder is concerned?

Mr. **Plank**. The partner or unit holder is still going to pay not only a capital gains tax but a recapture tax on sale of his interest.

Senator **Danforth**. Let me rephrase the question. If I were a unit holder or somebody who was considering being a unit holder, and I said to you, Mr. Slocum, without any reference to tax consequences or to the Internal Revenue Code, could you explain the difference of my status if I were a partner in your company or if I were a stockholder in a corporation. How would you explain that to me?

Mr. **Plank**. I think I will let Mr. Slocum speak on that.

Senator **Danforth**. Could you explain it too?

Mr. **Plank**. I think I could.

If a small investor comes to his broker and wants to buy a partnership unit in oil and gas, properties, he will be told that to the extent his return from that investment represents cost depletion, it will not be taxable to him.

Now if he were to buy an interest in a corporation and moneys were paid out in the form of dividends, the entire dividend would be ordinary income. But, of course, they wouldn't be likely to be paid in the first place, because to the extent that the corporation was engaged in business other than in liquidation, those moneys would probably be reinvested in the business. But the broker would be saying that a partner would be likely to treat a part of his distribution as a return of capital and that would be the difference.

Senator DANFORTH. In other words, it's not a dividend? It's not taxable as ordinary income?

Mr. PLANK. No.

Senator DANFORTH. In fact, you are getting a loss probably.

Mr. PLANK. If there were no cost depletion, then it would be fully taxable.

Senator DANFORTH. Oh.

Mr. PLANK. And the partner is taxed when he sells it, at a time when its basis has been reduced by the cost depletion.

Senator DANFORTH. Again, other than tax consequences, can you describe to the person whose difference in status is a partner as opposed to what a stockholder is of a corporation?

Mr. PLANK. Well, he becomes a unit holder and it would be slightly more complicated.

Mr. SLOCUM. Senator, it may also be worth pointing out that such a unit holder has all the dissimilarities other than transferability, associated with being an owner in a partnership structure as opposed to a corporation. One of the more important is the distinction he has vis-a-vis a shareholder with respect to creditor rights. In the event that the general partner is irresponsible in making a distribution against the prior claim of the creditors then the limited partner may be obligated to regurgitate those distributions in favor of the creditors—something to which the shareholder is not exposed.

Second, of course, the voting rights are limited by the terms of the partnership agreement and not subject to corporate law, and, therefore, more limited in representing his interest, perhaps in a catastrophic or problem situation.

Mr. PLANK. Could I add one thing further? The partnership has no employees, sir. The general partner employs the people that are associated with these. You don't have those characteristics in a corporation.

Mr. SANDLER. Senator, that may vary, I think, from one partnership to another somewhat because we do have, in fact, employees within our partnership. It's not meaningful. But the voting rights are different between a corporation and a partnership. In a corporation you have a proxy statement that goes out and in effect a majority in interest of your shareholders' control the corporation and control the business and management of that corporation. In fact, with a partnership, neither the limited partners nor their assignees, the unit holders, if you will, can take, active part in the management of the partnership. In fact, if they did they might be deemed to be general partners. So there are some substantive differences between corporations and partnerships besides tax differences.

Senator **Danforth**. Gentlemen, thank you very much.

[Whereupon, at 4:35 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

ARTHUR ANDERSEN & CO.

BYRLE M. ABBIN
MANAGING DIRECTOR
OFFICE OF FEDERAL TAX SERVICES

1666 K STREET, N. W.
WASHINGTON, D. C. 20006
(202) 862-3368

November 2, 1983

Honorable Robert Dole
United States Senate
Committee on Finance
Washington, D.C. 20510

Dear Senator Dole:

These comments are submitted in response to Press Release No. 83-186 of the Senate Finance Committee, and with respect to a hearing on reform of corporate taxation held October 24, 1983. While we have many clients who will be affected if the proposals set forth in the staff's report are implemented, this submission is not made on behalf of any client, but instead, represents our recommendations on these issues as an international accounting and consulting organization.

In general, we support the announced objective of the staff report. The rules governing corporate/shareholder relationships and the rules dealing with the acquisition of one corporation by another are in need of thorough review towards an ultimate goal of simplification and certainty. However, we would also like to point out that, while the present law in this area is complicated, relative certainty already exists because of the large number of cases, regulations and rulings that have been issued over the many years these rules have been in existence. In addition, we do not believe that the acquisition provisions of current law have been systematically abused. Rather, we believe that the current rules have operated rather efficiently since the fundamental principles were established almost 50 years ago. Similar observations would be true of the partnership aspects of the staff report.

In addition, changes of the magnitude proposed by the Senate Finance Committee staff would necessarily cause dislocations and uncertainty for a substantial period of time. This was most recently evidenced by the changes made to the rules governing taxable acquisitions in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). TEFRA repealed Section 334(b)(2) and created a new Section 338 to prescribe the treatment of taxable stock acquisitions as asset acquisitions. That provision, which was nominally a reform and simplification provision, is clearly more complicated than prior law. It has already been modified by one technical corrections act and another revision is proposed. In addition, despite the fact that this provision was enacted over 14 months ago, the Treasury Department has been unable to issue regulations to provide taxpayers with guidance in complying with the provisions of the statute and has actually requested public assistance in preparing regulations. Therefore, while we believe that review of the staff report should move forward, we also believe that changes in corporate taxation should come only after a systematic deliberation by members of Congress, the organized bar, certified public accountants, and other interested persons.

With that background, we will confine our comments to the issues set forth in the Committee's press release.

I. REPEAL OF THE "GENERAL UTILITIES" PROVISIONS

We strongly disagree with the staff's recommendation to repeal the General Utilities provisions, especially in the context of taxable corporate acquisitions and liquidations. As a preliminary matter, in our view, there is nothing inherently "bad" about mergers and acquisitions. Indeed, such transactions typically involve the free flow of capital to efficient uses and creates more positive business results through the effects of business synergism. These transactions also allow growing companies to avoid costly startup efforts. In many situations, mergers and acquisitions allow family companies to be acquired, thus fulfilling the financial and business desires of these parties. Thus, we believe that the tax rules in this area should be "neutral" and should not constitute an economic disincentive to such transactions.

Obviously, the staff's proposal amounts to a major expansion of the system of double taxation, and seems to run contrary to the recent trend that has focused on elimination of the system of double taxation on corporate earnings. Specifically, this proposal amounts to an expansion of the taxation of capital gains from 20% to 42.4% if the corporate form is used. For example, under current law, if a corporation holds an undeveloped piece of real estate, adopts a plan of complete liquidation, sells the undeveloped real estate (i.e., raw land) and distributes the sales proceeds to its shareholder, only a shareholder level capital gain tax, with a maximum rate of 20%, will be incurred. We believe that this approach is entirely appropriate, because the tax incurred in this situation is exactly the same as it would be had the owner of the company not held the real estate in corporate form. On the other hand, if the staff's proposals are enacted, the tax liability incurred in this situation would be 42.4% of the proceeds realized on the sale. For example, assume that there is a $100,000 gain on the sale of the land. First, the corporation would incur a $28,000 tax liability on the sale, leaving $72,000 to be distributed to the shareholder. The shareholder would incur a $14,400 tax on the liquidation, for a total tax liability of $42,400.

We do not believe that this result is justified. That is, it provides a much greater tax liability than would have been incurred had the corporate form not been chosen by the owner of the real estate, and thus provides a substantial economic disincentive to the use of the corporate form. In addition, given the strict statutory restrictions that limit the availability of S corporation status, we believe that many closely held entities will not be able to escape the harsh result of the staff proposal.

The practical impact of this proposal, if enacted, would be that taxable acquisitions in which the acquiring corporation receives a basis step up in the assets of the target corporation to reflect the purchase price (i.e., the purchaser's economic investment), would be eliminated. This is because no purchaser in this situation will choose to make a basis step up unless the incremental tax benefits received, considering the period in which such benefits will flow through the acquiring company's tax return, on a present value basis, is greater than the up front tax liability incurred in a taxable acquisition. Set forth in Exhibit I are examples of three types of property that would typically be acquired in a corporate acquisition. As can be seen, the only time it would make sense to do a basis step up would be where the target corporation's assets were entirely nonordinary income or recapture assets, and where the acquiring corporation would be able to elect to claim investment tax credit and a five year life for ACRS depreciation purposes. It would be rare to envision a target company that would hold only this type of asset. Accordingly, it would almost never be to the benefit of an acquiring corporation to make this election.

To support our proposition further, another example of the effect of the proposed rule is set forth below:

> Suppose that Individual A formed Corporation X 30 years ago, and Individual A owns all of the stock of Corporation X, having a $100,000 basis in such stock. Individual A wishes to retire and does not have any family members to whom he will turn over the business. Accordingly, Individual A wishes to sell Corporation X to an unrelated corporation, Corporation Y. Y is willing to acquire the assets of X for $8,000,000. Therefore, it is proposed that Corporation X will sell its assets to Y for cash and will then completely liquidate. Assume X has an effective tax rate of 46%. X holds the following assets:
>
> 1. Inventory -- LIFO basis $500,000; current FIFO cost $1,000,000; FMV $2,000,000.

2. Land -- Basis $1,000,000; FMV $3,000,000.

3. Machinery -- Basis $1,250,000; original cost $2,500,000; FMV $3,000,000.

Current Law Result (assume Sec. 337 applies)

LIFO recapture (($1,000,000 FIFO cost - $500,000 LIFO basis) x 46%)	$ 230,000
Depreciation recapture (($2,500,000 original cost - $1,250,000 basis) x 46%)	575,000

Tax liability incurred by Corporation X	$ 805,000
	==========
A's tax liability (($8,000,000 - $805,000-100,000) x 20%)	$1,419,000

After tax cash	$5,776,000
	==========

Proposed Law Result

Gain on inventory (($2,000,000 - $500,000) x 46%)	$ 690,000
Gain on land (($3,000,000 - $1,000,000 x 28%)	560,000
Gain on machinery:	
Depreciation recapture (as above)	575,000
Remaining gain ($3,000,000 - $2,500,000) x 28%)	140,000

Tax liability incurred by Corporation X	$1,965,000
	==========
A's tax liability (($8,000,000 - $1,965,000 - 100,000) x 20%)	$1,187,000

After-tax cash	$4,848,000
	==========

As can be seen, the proposed change would dramatically impact the tax liability incurred by Corporation X, and would correspondingly decrease the after tax proceeds received by A on the sale of the closely held business.

Accordingly, set forth below is a summary of the economic results that we believe would occur if the staff's proposals in the liquidation area were enacted:

1. Adverse Impact on Target Companies -- Because, as set forth in the example above, an acquiring corporation will not, for practical

purposes, be able to obtain tax basis in the acquired corporation's assets equal to the economic cost of its investment, we believe that acquiring corporations will be willing to pay less to acquire target corporations. For example, if an acquiring corporation wishes to obtain a 10% after tax return on its investment, the tax benefits associated with current law allow it to make a relatively larger payment for the target corporation than the proposed new rules would permit. Therefore, the effect of this proposal will be to diminish the value of target corporations. This seems a harsh penalty for small businesses or closely held entities. This economic distortion is further exacerbated by the fact that many of the gains involved are not true economic gains. Rather, they are gains largely attributable to inflation. Simply put, we believe that it is fundamentally unfair to further tax the inflationary gains of corporations at higher rates than would have occurred had the business been conducted as a sole proprietorship or as a partnership.

2. Enactment of the Proposals Would Provide a Further Disincentive to the Use of the Corporate Form. As illustrated above, enactment of the staff's proposals would result in a higher overall effective tax rate than if the business had not been incorporated. Simply stated, competent professionals will advise clients that the use of a regular corporation to conduct business operations will significantly diminish the owner's after tax value of the business when compared to the use of other forms of ownership such as

partnerships or S corporations. Since nontax considerations encourage the use of the corporate form, it seems unsound policy to discourage the use of this business entity.

3. The Proposals Would Favor Publicly Held Corporations. We also believe that the proposed changes will create a bias for publicly held corporations to acquire target corporations, and diminish the opportunity for privately held corporations to make similar acquisitions. The new proposals would encourage acquisitions using stock of an acquiring corporation. Obviously, the shareholders of the target corporation would prefer to take stock in a publicly held acquiring corporation that can later be sold on established securities exchanges, rather than accept stock of a privately held corporation, that, in many instances, is not readily marketable.

4. The Proposals Would Hurt the Ability of American Business to Compete in the World Market. Since the proposals would expand the system of double taxation, it would provide owners of acquired businesses with less after tax capital to reinvest in income producing activities. The staff proposals create a system in which the appreciation in all corporate ordinary income assets is taxed at a maximum rate of 73% ((1.00 x 46%) + (.54 x 50%) = 73%), in which taxation of corporate capital assets sold in the termination of a business are taxed at a rate of 42.4% ((1.00 x 28%) + (.72 x 20%) = 42.4%), and ordinary income assets are taxed at 56.8% ((1.00 x 46%) + (.54 x 20%) =

56.8%). It can readily be argued that on a comparative basis this after tax yield on income puts American businesses at a substantial economic disadvantage when competing in world markets with corporations formed in other developed countries that have a lower effective tax rate on corporate earnings.

II. ELIMINATION OF THE EARNINGS AND PROFITS CONCEPT

While we agree with the staff that the current concept of earnings and profits is, to some degree, inadequate, we do not agree with the proposal to eliminate that concept in determining the taxability of corporate distributions to shareholders. Essentially, we believe that the concept of earnings and profits is a generally effective measure to determine when distributions from corporations to shareholders ought to be taxed as a distribution of that corporation's increase in wealth attributable to earnings.

We also believe that the proposed repeal of this concept would amount to a constitutionally challengeable tax on capital. The staff has argued that the Supreme Court has effectively precluded any constitutional challenge by its decision in U.S. v. Phellis, 257 U.S. 156 (1921). We believe that case, which involved a dividend after a stock sale, is distinguishable in form and in theory from imposing ordinary income dividend treatment where a corporation has no earnings and profits. Specifically, a decision on identical facts but contrary to the Phellis rationale would have opened up capital gain bailout opportunities where a corporation had earnings and profits. However, Phellis is fundamentally different from the current proposal, which would, in our view, amount to an unfair tax on a return of capital.

To illustrate this point, suppose an individual forms a corporation with $1,000 worth of business assets and $1,000 in cash. Over a five year period, the corporation loses a total of $500, so that at that point it holds $1,000 worth of business assets, as well as $500 in cash. At the end of year five, if the corporation distributes $250 to its shareholder, under current law, that distribution would be treated as a return of capital. However, under the staff's proposal, this distribution would be treated as an ordinary income dividend distribution. We believe that the unfairness of this result is apparent. That is, the shareholder is really receiving back part of his original investment, which ought not to result in any tax at all.

It is apparent that the staff proposal is based on a presumed benefit to individual shareholders purchasing stock in a corporation with no earnings and profits on a tax basis, but which is making current distributions. We believe that the report ignores complex policy issues in discussing whether such distributions ought to be treated as return of capital distributions. That is, if the analysis is made solely from the standpoint of the individual shareholder, obviously current law results in converting what might economically be viewed as dividend income into a capital gain. However, the report ignores the result under current law that allows certain publicly held corporations to raise capital at a lower economic cost. These reduced costs provide benefits to the customers of such companies.

On an overall basis, we agree that the concept of earnings and profits needs to be studied further. We also support the creation of greater certainty in this complicated and nebulous area through the enactment of more objective rules in defining the computation of earnings and profits.

We agree with the staff report's observation that there are certain unwarranted loopholes in this area. Two examples that come to mind are the issuance of original issue discount obligations as distributions to shareholders and so-called "nonliquidating" Section 368(a)(1)(C) reorganizations. However, rather than repeal the concept of earnings and profits, we believe that abuses should be foreclosed by legislative action.

III. LIMITATION ON THE ABILITY OF A CORPORATION TO RECEIVE A DIVIDENDS RECEIVED DEDUCTION

The goal of the dividends received deduction under Section 243 is well documented. Namely, the provision attempts to limit, to the greatest extent possible, the potential for more than double taxation on distributed corporate earnings. However, in enacting the dividends received deduction, Congress recognized that the favorable treatment for corporate shareholders should not be used as a tax arbitrage to convert 46% tax liability into 6.9% tax liability. Historically, it has been felt that this rule would not be used for wide spread tax arbitrage, provided that the corporate investor faced significant economic risk for a sufficient period of time. Thus, there is a requirement under current law of either a 15 day or 90 day holding period in order to obtain the benefits of the dividends received deduction.

The staff report identified two areas of potential abuse. The first concerned the borrowing of funds to invest in the preferred stock of an unrelated company. Through the receipt of a deduction for the interest on the borrowing, as well as the dividends received deduction, a large favorable after-tax cash flow could be obtained. The second potential abuse dealt with techniques to significantly limit the risk of a corporation buying a stock investment in another company. The limitation on risk could take two forms. The first would be to hedge the risk through the purchase or sale of a similar investment unit. The second would be if a dividend distribution was very large in relation to the initial economic investment, then the capital loss possibilities inherent in the tax basis rules in this situation could significantly eliminate or decrease the market risk of the corporate investor.

Therefore, we agree with the staff that this area needs to be dealt with. However, we are unable to agree with the staff proposals. First of all, we feel that a one-year holding period to be eligible for the dividends received deduction is probably too long. That is, we feel that it will override the original objective of Section 243 in many more situations than is justified by the current problems in this area. (It has been our experience that transactions like the ones associated with the 1983 Chrysler dividend are relatively isolated.) We feel that either the one-year holding period should be shortened or that the holding period requirement to obtain the dividends received exclusion should be correlated in some manner by comparing the size of the dividend distribution to the initial economic investment.

With respect to the staffs' proposal to disallow 85% of interest on debt incurred to purchase or carry stock producing dividends eligible for the dividends received deduction, we have serious concern as to how this "objective" rule would work in the real world. That is, it would be difficult to accurately trace such interest on the tax return. As a practical matter, we believe it would create tremendous uncertainty for otherwise legitimate economic investments.

On an overall basis, we believe that further study of this problem is warranted particularly in light of the possible impact of these proposals on the capital markets.

IV. NET OPERATING LOSSES

For the reasons stated below, we believe that the effective date of Section 382, originally enacted as part of the 1976 Tax Reform Act, should be delayed for another year. This should provide adequate time to discuss the concerns addressed below.

Once again, we agree that legislative action is necessary in this area. We also agree with the staff that the legislative proposals should be related to the continuity of shareholder interest, continuity of business enterprise, and income averaging theories underlying the net operating loss (NOL) carryforward provisions of Section 172. At the present time, while we are studying this matter further, we have two comments on the staff's proposal. First we believe that, if possible, there should be a single rule consistently applied to all types of acquisitions involving NOL companies. Essentially, we believe that differences in result should not be obtained in this area merely by changing the form of the transaction, while the underlying economic consequences, absent favorable tax attributes, are identical.

Our second concern is the rule allowing purchase of NOLs under an assumed rate of return. We feel that the staff's proposal is a reasonable way to approach this problem, but it would not work well in all situations. First, since the assumed rate of return would float with the Section 6621 rate, the purchaser might have difficulty in determining how much of the NOL carryforward it would be able to utilize since the rate of return under Section 6621 would change every six months. The second problem is that, in certain industries, particularly the high technology industries and in startup companies, the real rate of return generated by business operations, once they become profitable, can be quite a bit higher than 125% of the Section 6621 rate.

Accordingly, we feel that the assumed rate of return under this proposal ought to be the higher of 125% of the Section 6621 rate as under the staffs' proposal or the actual rate of return on the purchaser's investment generated by the pool of capital which produced the loss. Since most purchasing companies consider the probable rate of return of a target corporation in determining the amount of their economic investment, our proposal would allow a more realistic determination of how much of the target corporation's NOL they would be able to utilize, and thus, the fair market value of the company.

V. PUBLICLY TRADED PARTNERSHIPS

A large body of law exists defining partnerships. All of those rules acknowledge that partnerships are fundamentally pass-through entities and not "tax-exempt business enterprises." Coherent and consistent rules are found in Section 761(a) of the Code and in Section 7701(a)(2). The Supreme Court interpreted the present statutory definition in Morrissey v. Commissioner, 296 U.S. 344 (1935). The present regulations under Section 7701 are based on the listing of corporate characteristics addressed in Morrissey. Those characteristics are:

1. Associates,
2. An objective to carry on business and divide the gains therefrom,
3. Continuity of life,
4. Centralization of management,
5. Liability for corporate debt limited to coporate property, and
6. Free transferability of interests.

Case law, regulations and Internal Revenue Service rulings have consistently determined the classification of an organization for tax purposes as a partnership or as a corporation by an analysis of the six characteristics listed above. The first two characteristics (associates and joint profit motive) are essential to both corporations and partnerships. Consequently, these characteristics, although essential to the definition of a partnership, do not distinguish it from a corporation. The remaining four corporate characteristics comprise the present litmus test in distinguishing a partnership from a corporation. The regulations provide, and the courts have held, that an organization possessing three or more of the remaining four corporate characteristics will be treated as an association taxable as a corporation, whereas an organization possessing fewer than three of these characteristics will not be treated as a corporation.

The tests described above demonstrate two fundamental principles. First, the current classification system has evolved over a long period of time and has been molded through litigation, administrative process and learned commentary. To suggest that this process should be summarily reversed ignores well established precedent and distinctions between partnership entities and corporate solution. Second, if publicly traded limited partnerships are as closely akin to corporations as the staff report states, the mechanism for treating them as associations taxable as corporations is already in place and no legislation is required.

Actually, there are numerous legal differences between a publicly traded limited partnership and a publicly traded corporation. While the specific differences vary among jurisdictions, a few of the more common and significant ones are:

1. The retirement, death or insanity of a general partner dissolves the partnership, unless the business is continued by the remaining general partners under a right to do so stated in the certificate of limited partnership or with the the consent of all the partners. A corporation's duration is normally perpetual. A limited partner assumes a significant business risk that he could suddenly own an undivided interest in a dissolved partnership's assets.

2. The general partners of a limited partnership have unlimited personal liability for partnership debts. No corporate shareholder has such liability. This is a very real business risk, and assuming the general partners, as a group, have substantial assets, they are put in a significantly different risk posture than owners of a corporation.

3. A limited partner generally can be forced to return excess distributions even if the excess was not known at the time of the distribution where a shareholder normally cannot be held so accountable.

The tax law provides flexibility in the choice of the form in which one does business. The law allows for tax-free incorporation in most cases, to allow a change in entity without tax consequences where there is no economic change. The same is true upon formation of a partnership. (It should be pointed out that the formation of a partnership from an existing corporation has the potential for significant current tax liabilities due to investment tax credit recapture and other recapture provisions. This facet of current law is another reason publicly traded limited partnerships are confined to certain types of activities and investors.) The current law provides, in certain cases, for corporations with 35 or fewer shareholders to elect to be treated as an S corporation and thus be treated much more like a partnership than a corporation.

The proposal to treat publicly traded partnerships as corporations is a clear departure from established principle, and totally changes a concept that has withstood the test of time. The partnership is a pass-through entity. One of its primary characteristics as such is that there is no tax at the entity level. The staff proposal would impose a tax on the entity, and thus abrogate a long-established doctrine of tax law, the laws of business association, and principles that are well articulated in case and statutory law.

A stated intent of the staff report is a desire to tax like entities alike. There are numerous exceptions to that proposition in the current law (e.g., S corporations, REITs, life insurance companies, savings institutions, DISCs, etc.). Nevertheless, the staff report argues that publicly traded limited partnerships are too similar to entities that are taxed as corporations. It is equally arguable that some closely held corporations are "too similar" to entities that are properly taxed as partnerships. The logical extension of this apporach would be to tax all publicly traded partnerships as corporations and all closely held corporations as partnerships. This, of course, ignores the real differences between the two forms of conducting business.

It has long been recognized that the four corporate characteristics discussed above have been equal determinative factors in classifying partnerships as partnerships or as associations taxable as corporations. To now suggest that one factor is determinative, such as whether instruments are traded on a listed exchange, would disregard the other substantive differences.

Administrative Issues. The staff report states that "substantial questions have also been raised whether the partnership tax rules work effectively for publicly traded limited partnerships." Since these "questions" were not enumerated, we can not address them individually. The following is intended to explain the application of the partnership rules to publicly traded partnerships.

It is a basic tenet that the more often an interest changes hands, the more difficult it becomes to compute and report the tax attributes of each partner. However, given the current capabilities of computers, and the level of technical competence available to publicly traded limited partnerships, these problems are certainly manageable. The present regulations provide adequate guidance for allocating and reporting partnership items in situations involving interim sales and/or exchanges of partnership interests. Sales of partnership interests are not new. Sales through brokers involving interests held in "street name" are new. We appreciate the necessity for providing tax information to the true owners of partnership interests, but strongly believe that this information is readily available and should be obtainable from brokers by both the Internal Revenue Service and general partners. Any problems associated with holding partnership interests in street name can be solved if adequate reporting is required by the nominees. The answer is to identify the problems, provide clear guidance for what information is required, from whom it is required, and when it is needed and then enforce those requirements.

Problems of Internal Revenue Service examinations were greatly reduced by the enactment of the Tax Equity and Fiscal Responsibility Act of 1982. By allowing partnership level examinations and requiring consistent reporting or disclosure by all partners, the Internal Revenue Service has accomplished a large part of its objectives relating to large partnership administrative matters.

Administrative difficulties are not unique to publicly traded limited partnerships. Any large entity, such as a real estate investment trust, has similar problems. Those tasks are even more manageable today with the aid of computers.

Although footnote 60 in the staff report discusses the 676 partnerships in 1980 that had over 1,000 partners, there are currently fewer than 20 publicly traded limited partnerships. These partnerships are subject to extreme scrutiny by federal and state securities commissions, as well as by the investing community. This scrutiny is coupled with the analysis of attorneys, accountants and underwriters who have the expertise and responsibility to develop high quality, sound and conservative tax structure. Publicly traded partnerships are not likely to be the kinds of abusive tax shelters characterized by faulty allocations, lack of economic substance or overvaluation of assets.

The use of publicly traded limited partnerships has been mainly confined to the oil and gas area. This vehicle has provided a means for stimulating production in energy resources that might well go untapped. There are investors in these partnerships that might never have invested in a corporation engaged in oil and gas production. A comparison of the shareholder list of any predecessor corporation with the partner list of the resulting limited partnership should show a significantly different investor mix.

The real losers in this proposal may well be small investors. While wealthy individuals will always be able to find and qualify for sound partnership investments, the same cannot be said for more moderate income investors. This provision will effectively preclude the middle income investing population from numerous investment opportunities. It may also have the unintended effect of increasing the number of marginal economic partnerships that are being marketed to middle income investors by eliminating other more economically sound investment opportunities.

Conclusion: Although the staff report raises a valid concern regarding the similarity of publicly traded limited partnerships and corporations, it is not a new concern. The staff solution to an extremely complex and technical question is too simplistic and shortsighted. The mechanism for taxing like entities alike is already in place and should be used in appropriate situations. Any administrative abuses perceived by the staff if specifically identified can be addressed by means less radical than redefining partnership principles.

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Comments on Sections I-IV were prepared by Earl Brown, 33 West Monroe, Chicago, Illinois 60603, (312) 580-0033. Section V was prepared by Tom Gotliboski, 711 Lousiana, Suite 1300, Houston, Texas 77002, (713) 237-2828. Questions on these sections should be addressed to them as appropriate.

Very truly yours,
ARTHUR ANDERSEN & CO.

By
Byrle M. Abbin

November 2, 1983

Mr. Roderick De Arment, Chief Counsel
Committe on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. De Arment:

We are enclosing herewith a written statement for inclusion in the printed record of the Senate Finance Committee hearing held October 24, 1983 regarding "Reform and Simplification of the Income Taxation of Corporations". Our statement specifically addresses the proposed changes to the corporate 85 percent dividends received deduction.

Robert W. Baird & Co., Inc. is a regional brokerage house located in Milwaukee, Wisconsin. We are members of both the New York and American Stock Exchanges.

We and our clients (both individual and corporate) are very concerned with the proposed legislation relating to the dividends received deduction. We feel that the proposed changes relating to extending the required holding period and disallowing interest expense to carry stock subject to the exclusion are unwarranted. The existing law, with its 15 day holding period requirement, is more than adequate to insure that transactions are not entered into solely for tax avoidance purposes. We feel that the abuses perceived by the Committe's staff can be eliminated through the staff's proposal to increase the basis of stock sold short by the amount of payments made in lieu of dividends. This proposal, modified to not apply to dealers in securities, would be specifically targeted at the current abuses.

It is our opinion that the proposed changes to the holding period and the deductibility of interest go against the purpose of originally enacting the dividends received deduction which was to prevent the multiple taxation of corporate earnings. These proposed changes would radically effect the market value of billions of dollars worth of stock, especially preferred stocks. In addition, the changes would not clearly reflect the economic results of the transaction the changes would apply to and would cause administrative problems for taxpayers.

We wish to thank the Committee for considering our statement. We encourage the Committee to abandon the proposed changes to the holding period and the deductibility of interest and concentrate on the proposal to increase the basis of stock sold short to curb abuses.

Very truly yours,

ROBERT W. BAIRD & CO., INC.

ROBERT W. BAIRD & CO. INCORPORATED, 777 EAST WISCONSIN AVENUE, POST OFFICE BOX 672, MILWAUKEE, WI 53201
MEMBER NEW YORK STOCK EXCHANGE, INC. AND OTHER EXCHANGES

WRITTEN STATEMENT TO SENATE FINANCE COMMITEE
REGARDING HEARING ON OCTOBER 24, 1983
RELATING TO "REFORM AND SIMPLIFICATION
OF THE INCOME TAXATION OF CORPORATIONS"

The Senate Finance Committee staff, in its report on "REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS," released September 22, 1983, advocates that the minimum holding period for stock necessary to qualify for the corporate 85% dividends-received deduction would be extended from the current 15-day holding period to one year. In addition, the Committee staff contemplates amending §265 of the Internal Revenue Code to disallow 85% of the interest on debt incurred to purchase or carry stock producing dividends eligible for the corporate 85% dividends-received deduction.

Legislative History of Dividend Exclusion

Internal Revenue Code (IRC) §243(a)(1) provides generally that 85% of the amount received as dividends from a taxable domestic corporation, may be deducted by a corporate taxpayer. This provision can trace its history to the Revenue Act of 1918, which allowed a corporate credit for all dividends received by one corporation from another. The reasoning behind the original enactment of the dividends-received credit may be found in the requirement that the payor corporation be subject to income taxation. This reflects legislative purpose of the deduction as a means of mitigating the multiple taxation of corporate earnings (Bittker and Eustice, 4th Edition Para. 5.06).

The 100% credit was changed to the present 85% deduction by the Revenue Act of 1935. This change was enacted in order to prevent a series of holding companies from evading the graduated tax by a means of a multiplicity of corporations, House of Representatives Report No. 1681, 1939-1CB(Part 2) 642, 647.

Effect on Debt versus Stock Investments

The Committee staff argues that the dividends-received deduction on stocks distorts investment decision-making since it arbitrarily skews the corporate investor's decision-making in favor of stock and against corporate debt. This position does not take into account the double taxation of dividends. While it is true that a corporation is taxable in full on its interest income, it is also true that the payor corporation receives a corresponding tax deduction. Such is not the case where dividends are involved. The payor corporation receives no tax deduction for the dividends paid, while the payee corporation receives, at most, an 85% deduction. Thus, at least 15% of the dividend received is subject to double taxation.

The necessity of avoiding multiple taxation of corporate earnings is especially true in the case of preferred stock. Preferred stock is a hybrid instrument that has attributes of both debt and equity. Preferred stock tends to be quite interest rate sensitive and, thus, the market views preferred stock as being similar to corporate bonds. However, whereas the interest paid on bonds is deductible by the payor corporation, the dividends paid on preferred stock are not. This fact tends to create a bias in favor of corporate debt under the tax laws. A limiting of this deduction would further this bias in favor of debt.

It would seem apparent then, that the dividends-received deduction acts to somewhat mitigate the bias in the tax law towards investing in bonds rather than stocks. The dividends-received deduction also tends to balance the market values of equity investments and bonds for the same reasons.

Elimination of 85% of Interest Expense on Debt

The Committee staff report provides that 85% of any interest on debt used to carry stock-producing dividends eligible for the dividends-received deduction would be nondeductible. This provision fails to consider the overall purpose of the deduction, which is to alleviate the multiple taxation of corporate earnings.

The proposed 85% reduction of interest expense fails to clearly reflect the economic reality of the transations it proposes to apply to. This may be illustrated by the following example:

Dividends received	$ 10,000
Related interest expense	(12,000)
Disallowed interest expense	10,200
Taxable income before deduction	8,200
Dividends received deduction	(8,500)
Taxable income	$ (300)
Tax benefit at 46%	$ 138
Interest paid	(12,000)
Dividends received	10,000
Net cash flow	$ (1,862)

In this example, the taxpayer suffers a $2,000 economic loss (before taxes) by borrowing funds and purchasing the stock. One would expect that the after-tax economic effect would be a loss of $1,080 ($2,000 less 46% tax effect). However, the actual economic effect under the proposal is a loss of $1,862. This means that the taxpayer receives a tax benefit for his $2,000 economic loss of only $138 which equates to only 6.9%.

In addition, a provision reducing deductible interest appears to be overbroad, especially in light of the fact that the dividends-received deduction will not necessarily be a strict 85% in all cases. This is so because the dividends-received deduction is limited to a corporation's taxable income. Because this proposed provision does not take such a limitation into account, it would effectively tax the net earnings of corporations more than twice at the corporate level.

Extension of Holding Period

The extension of the minimum holding period for stock on which dividends would be eligible for the dividends-received deduction to one year from the present 15-days presents even greater problems. The 15-day rule was enacted by the Technical Amendments Act of 1958. The Congress saw situations where corporations were buying stock just before a dividend was payable with the intention of receiving the dividend and then immediately selling the stock. In such cases, the selling price of the stock, other things being equal, would be less by approximately the amount of the dividend. Thus, the corporation would receive dividend income against which it could take a deduction for 85% of the amount received and a loss of approximately the same amount, which could be offset against capital gains. The purpose of enacting the 15-day rule was to increase the market risk borne by the purchaser to ensure that transactions were not entered into soley for tax avoidance purposes.

The staff's proposal to curb this perceived abuse fails to clearly reflect the economics of such a transaction. The following example illustrates this point:

Cost of purchasing stock	$(110,000)
Dividend received	10,000
Sales proceeds	100,000
Net cash flow before taxes	-
Tax benefit of loss at 28%	2,800
Proposed tax on dividend at 46%	(4,600)
Net cash flow	$ (1,800)

The staff's proposal would exact a net tax of $1,800 on a transaction that produced no economic gain. This results from the rate differential between capital losses (maximum of 28%, 0% if the taxpayer has no capital gains to offset) and ordinary income (maximum of 46%).

The House version of the 1958 Bill contained a 10-day holding period; however, the Senate, in its version felt that a 15-day holding period would give greater assurance of minimizing tax avoidance as the primary purpose for the investment. Since 15 days more than adequately covers any exdividend rules of the major security exchanges, it would seem superfluous and unnecessary to increase the holding period to one year. In addition, the current 15-day holding period provides an adequate period to ensure that the investor bears the risk of market fluctuations in the price of the stock. This is because of the volatility of common stock prices and the movement of preferred prices with market interest rates.

Increase in Basis for Payments in Lieu of Dividends

The staff has raised concerns about taxpayers taking offsetting positions in common and preferred stocks, using in-the-money calls and selling substantially similar shares short to avoid the economic risk provided by the current 15-day holding period. We believe that these are indeed abuses and should be dealt with.

The Committee staff's third proposal is to increase the basis of stock sold short for payments made in lieu of a dividend. We believe this proposal will effectively curb these abuses. The proposed one-year holding period would be overly broad and reach many legitimate transactions which are not abuses. The staff's proposal to increase basis focuses on specifically those transactions that are set up for tax avoidance purposes.

We would modify the staff's basis proposal to make it inapplicable to dealers in stocks. This is because dealers, in their role of facilitating the nation's capital markets, often take short positions and make payments in lieu of dividends in order to help keep an orderly market in these stocks. Since these transactions by dealers are undertaken for valid economic reasons, they are not abusive and, therefore, should not fall under the increased basis proposal.

Effect on Capital Markets

In essence, the Committee's proposed one-year holding period not only will act to depress the capital markets, but will also restrict the function of the capital markets. It will also operate to restrict a corporation's ability to manage their investments.

An increase in the dividend deduction holding period would have a detrimental effect on the market for preferred stocks. A requirement that stock be held for one year to qualify for the dividends-received deduction would reduce investment flexibility and adversely affect the liquidity of corporate investors. This could result in a depressed market value for billions of dollars of outstanding preferred stocks which could lead to severe economic hardship not only for the issuing corporations, but also for corporate and individual investors.

A required one-year holding period would also have an adverse effect on dealers who help maintain a market in certain stocks. In order to facilitate the capital market, dealers keep an inventory of the stocks in which they deal. Such a restriction on the holding period for preferred stocks would cause these dealers to be less inclined to hold any particular stock in inventory because of the potential for a reduced yield through a loss of the dividend deduction.

Administrative Problems

Furthermore, the Committee's proposed one-year holding period presents administrative problems for the preparation of corporate tax returns. If a corporation were to purchase a stock prior to its year end and also receive a dividend on that stock, it is quite possible that it would be unable to determine how to treat that dividend for the purposes of reporting taxable income. That is, if the corporation's tax return was due prior to the expiration of the one-year holding period, there would be no means of determining whether the full dividend was includable in income or only 15%. This would mean that either returns would be extended for longer periods of time or that the incidence of corporations filing amended returns would increase.

Conclusion

In conclusion, we feel that the Committee's proposed changes in the holding period required for the dividends-received deduction and the disallowance of interest expense on stock subject to the deduction are unwarranted. The preceding discussion of the history of the applicable

Sections indicate that the deduction was enacted into law to prevent double taxation and that the 15-day holding period requirement of present law is more than adequate in order to assure that the sheltering of income through the use of tax differentials does not occur. Furthermore, the Committee's proposed changes in these areas will have adverse effects on the flexibility of the capital markets. This would seem to be adverse to the government's policy during the present period in which the economy is staging a recovery; a time when investors' access to the capital markets is at a premium.

The elimination of the abuses perceived by the staff would be better accomplished by specifically targeting legislation at these abuses. We believe that the staff's third proposal of increasing the basis of stock sold short by the amount of payments made in lieu of dividends is sound and should be modified to provide an exception for dealers in securities. This proposal would then be specifically targeted at the current abuses and would effectively eliminate them.

ROBERT W. BAIRD & CO.
Member of New York and
American Stock Exchanges
777 East Wisconsin Avenue
Milwaukee, Wisconsin 53202

CRAVATH, SWAINE & MOORE

ONE CHASE MANHATTAN PLAZA
NEW YORK, N. Y. 10005

RALPH L. MCAFEE
HENRY W. DEKOSMIAN
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DANIEL P. CUNNINGHAM
KRIS F. HEINZELMAN
B. ROBBINS KIESSLING
ROGER D. TURNER

COUNSEL
MAURICE T. MOORE

TELEPHONE
212 422-3000

TELEX
RCA 233663
WUD 125547
WUI 620976

CABLE ADDRESSES
CRAVATH, N. Y.
CRAVATH, LONDON E. C. 2

3 HONEY LANE, CHEAPSIDE
LONDON EC2V 8BT, ENGLAND
TELEPHONE 1-606-1421
TELEX 8814901
RAPIFAX/INFOTEC
1-606-1425

November 2, 1983

Statement Relating to October 24, 1983
Hearing on Reform of Corporate Taxation

Dear Mr. DeArment:

On behalf of Blyth Eastman Paine Webber Incorporated ("BEPWI"), the following comments are submitted in opposition to the proposal to treat all publicly traded limited partnerships as associations taxable as corporations for Federal income tax purposes.

BEPWI has participated in a number of oil and gas "roll-ups", pursuant to which holders of relatively illiquid interests in oil and gas partnerships (or fee owners of oil and gas assets) exchange those interests for interests in a publicly traded "master partnership". For the reasons stated below, we do not believe that these master partnerships should be taxable as corporations.

First, to the extent that the concern relates to the so-called "disincorporation of America" (see Forbes, August 1, 1983, p. 76), the concern does not apply to roll-up transactions. The oil and gas assets transferred to the master partnerships are already in partnership form (or held directly in fee) before the roll-up. The roll-up in no way "disincorporates" any assets. Moreover, there does not appear to be any objection to the original creation of the small participating partnerships in non-corporate form. Therefore, there should be no objection to the consolidation of those small partnerships into the master partnership. To the extent the concern is disincorporation, any rule that is adopted should, at the very least, exempt partnerships the principal assets of which were never owned by a corporation. The same exception should apply (a) if the assets of the partnership were acquired from one or more corporations by purchase or lease, since there appears to be no abuse in this situation, or (b) if the assets of the partnership were acquired from one or more corporations in exchange for partnership interests, since there is no disincorporation in this case.

Second, to the extent the concern is tax administration of publicly traded partnerships, we do not believe the proposal is an appropriate solution. We understand the industry has gone to considerable trouble and expense to develop computer programs for proper tax reporting to partners.

Moreover, we understand the Treasury believes that the partnership audit provisions of the Internal Revenue Code are expected to be adequate for publicly traded partnerships. If present record keeping requirements and audit procedures for publicly traded partnerships prove to be inadequate, the proper solution is for the IRS to propose for comment additional record keeping requirements, or for Congress to strengthen the audit procedures, rather than for Congress to legislate such partnerships out of existence. We strongly object to the concept that ease of audit should be determinative of the tax status of an entity.

Finally and most fundamentally, we believe that as a policy matter, public trading should not automatically result in corporate status. A public market in partnership interests depends on the willingness of third parties to make a market. We do not believe this type of activity by third parties should be determinative of the status of an entity, particularly where the entity may have little or no control over the third parties. To our knowledge, tests for entity status have heretofore been limited (and we believe properly so) to an examination of the entity itself and its owners. Moreover, it seems difficult to justify the existence of a public market as an inherently corporate characteristic, without conceding that the lack of a public market is an inherently non-corporate characteristic. This would lead to the conclusion that there should be some kind of "mandatory Subchapter S" for non-publicly traded corporations. Not surprisingly, the proposed legislation does not go this far.

In addition, we believe that making public trading the critical test of status is so underinclusive and over-inclusive as compared to the apparent goal of the legislation as to be unwise on public policy grounds. In order to focus the issue, we note that under Treas. Reg. § 301.7701-2(e), an entity may be a partnership for tax purposes even though its interests are freely transferable (as long as it does not also have at least two of the other three corporate characteristics). As the proposed legislation does not deal with free transferability as such, but only with public trading, we assume the legislation is based on a concept that liquidity is a fundamental corporate (as opposed to partnership) characteristic.

The legislation does not, however, directly deal with the liquidity issue. On the one hand the legislation would not prevent partnership interests from being liquid, as long as there was no public market. (For example, a general partner of a large or small partnership might make a standing offer to buy partnership interests from existing partners at current value.) On the other hand, the existence of a public market would be fatal under the legislation, even though the market might be so thin that a potential buyer or seller would have considerable difficulty making a trade. We believe it would be impossible to define liquidity in a practical way that would clearly distinguish entities with liquid interests (i.e., corporations) from those with illiquid interests (i.e., partnerships). We therefore believe the approach of the proposal should be abandoned.

Respectfully submitted,

Michael L. Schler

Roderick A. DeArment, Esq.,
Chief Counsel,
Committee on Finance,
Room SD-219,
Dirksen Senate Office Building,
Washington, D. C. 20510

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THE CHICAGO BAR ASSOCIATION
29 South LaSalle Street
Chicago, Illinois 60603
(312) 782-7348

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October 18, 1983

Mr. Roderick DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. DeArment:

Attached is an outline of the position to be presented on behalf of the Executive Committee, Chicago Bar Association Federal Taxation Committee, at the Senate Finance Committee hearing to be held on October 24, 1983, on proposals for the reform and simplification of the income taxation of corporations and shareholders.

Sincerely,

Sharon L. King

Sharon L. King
Chairman
Federal Taxation Committee

SLK:mla
Att.

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OUTLINE OF CHICAGO BAR ASSOCIATION FEDERAL TAXATION COMMITTEE STATEMENT ON PROPOSALS FOR REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS

I. The method by which the Finance Committee Staff developed its report is commended. However, we suggest that, given the scope of the proposals, unhurried consideration by Congress would promote understanding of the proposals by the public and also probably elicit comments that will improve the proposals themselves.

II. Proposals for Corporate Acquisitions:

A. Executive Committee of the CBA Tax Committee generally supports the basic proposals (1) to permit corporate parties to an acquisition simply to elect to treat the acquisition as either a cost basis acquisition or a carryover basis acquisition regardless of the nature of the consideration used to effect the acquisition and (2) to separate the tax consequences of an acquisition to the shareholders of the corporate parties from those to the corporations themselves.

B. General Utilities. The Executive Committee of the CBA Tax Committee does not support the repeal of the General Utilities principle as proposed in the Report. Beyond that statement the views of the Committee are varied. We strongly believe that, if General Utilities is to be repealed, at the very least shareholders of liquidating corporations should be given a credit against the tax they incur on the liquidating gain for the tax paid by the liquidating corporation on its capital assets. An alternative of exempting the liquidating corporation from tax on capital assets is appealing and is perhaps simpler than allowing shareholders a credit. Finally, there is a fairly strong feeling among the Committee members that the rules of current law contained in Sections 311(a), 336 and 337 are preferred over the various proposals to repeal some or all of the General Utilities principle.

C. Our views on the definition of qualifying stock and asset acquisitions and the so-called selectivity rules are influenced by the decision that is made with respect to the General Utilities principle. In general, if the proposal to repeal completely the General Utilities principle were adopted, we believe that it is unnecessary to condition qualifying transactions on the acquisition of substantially all of the assets of a corporation or to guard against selective step up in basis by enforcing consistent treatment of certain transactions involving the same or related parties within a given time period. The imposition of a full corporate tax should be adequate to remove taxes as a factor initiating transfers. Also elimination of these limitations would greatly simplify the proposals and probably make them more even handed in operation.

On the other hand, if the proposal to repeal the General Utilities principle is not adopted, we believe that the definitions of qualifying acquisitions are reasonable and certainly are a substantial simplification of current law.

D. Carryover Basis Acquisitions. The Executive Committee supports the proposal to allow carryover basis treatment regardless of the nature of the consideration paid. Requirements imposed on reorganizations under current law, in particular the continuity of interest requirement, have little if anything to do with asset basis and tax attributes should carryover in an acquisition for cash. Indeed this result is available under current law by a purchase by one corporation of the stock of another for cash.

E. Cost Basis Acquisition. We support allowance of an election to treat an acquisition as a cost basis acquisition even if the consideration used consists solely of stock of the acquiring corporation. If the General Utilities principle of current law is retained, however, rules currently applicable to corporate sellers of assets (Section 337, etc.) should be applied to acquisitions for stock.

F. Boot Rules. The Committee supports replacing the rule of the Shimberg case with that contained in the proposal. Testing dividend equivalency by reference to the shareholders' interests in the acquiring corporation accords with the fact that the boot is typically funded by the acquiring corporation. Arguments in favor of this approach have been well made elsewhere and are noted in the Report. See, Levin, Adess & McGaffey, "Boot Distributions in Corporate Reorganizations - Determination of Dividend Equivalency," 30 Tax Law. 287 (1977).

III. Proposals for Limitations on Net Operating Losses.

A. The Committee generally believes that free transferability of net operating losses is preferred over any system intended to restrict some transfers but not others. We feel, however, that this view is unlikely to gain wide acceptance. Public reaction to the safe harbor leasing provisions of the 1981 tax legislation seems to support this feeling.

IV. Proposals for Distributions.

A. Our view on the repeal of General Utilities has been expressed.

B. Because we favor free transferability of losses we prefer the current rules of Section 382(a) to those made in the proposals. Generally these rules require not only a substantial change in ownership of the loss corporation but also a significant change in its business before losses are extinguished.

C. If the Congress feels that it must adopt a rule which prohibits sales of losses, the proposals are more likely to achieve that goal than the rules of current law or those slated to become effective next year. The two proposed rules have a common origin - that losses should be allowed to offset the income which the transferor of the losses could have earned based upon the value of the assets transferred. Because the foundations of the two rules is the same, we believe adopting a single rule would be preferred over adopting two rules. We recommend in that case that the rule denominated as the "Purchase Rule" govern all situations because it is the simpler to understand than the "Merger Rule."

B. Repeal of Earnings and Profits. We do not support this proposal for several reasons. First, we believe that distributions in excess of earnings, however defined, are returns of capital and should not be subject to double taxation as are distributions of corporate profits. Second, we are uncertain that the implications of this proposal have been adequately considered. For example, corporate taxpayers eligible for the dividends received deduction pay a lower tax on dividends than on capital gains. We can foresee cases in which corporations will arrange sales to create dividend income and capital losses. Third, much of the complexity inherent in calculating earnings and profits would be retained, for example for foreign corporations and affiliated groups of corporations. Thus, only modest simplicity is gained by the proposal. Of the several alternative proposals to repeal of earnings and profits, we are most troubled by rules fashioned for corporations with financial earnings. This proposal presumably would tax as dividends distributions by many public utilities that are currently taxed as returns of capital. This change could cause substantial dislocations in financings by such firms, and the implications of those dislocations need serious consideration. For example, adoption of such a rule would immediately reduce the value of shares of such firms held by persons whose purchase price for those shares took into account the taxation of distributions with respect to those shares.

C. Limitation on the dividend received deduction. We are troubled by coupling a one year holding period entitlement to the dividends received deduction. We understand that the 16 day rule of current law is viewed as too short to prevent transactions that are designed around this deduction, but we believe that one year is an unnecessarily long period to respond to that concern. Mutual funds, utilities and others will be unnecessarily adversely affected by the proposal.

IV. Proposals for Entity Classification.

We are not troubled by the fact that large, widely held organizations can operate in a form that results in their taxation as partnerships. The proposal to tax such organizations if their interests are publically traded is very narrow and places a great deal of emphasis on a single factor.

**COALITION FOR LOW
AND MODERATE INCOME HOUSING**

Suite 400 South
1800 M Street, N.W.
Washington, D.C. 20036
Telephone: (202) 457-6800

STATEMENT
of the
COALITION FOR LOW AND MODERATE INCOME HOUSING
Regarding Reform of Corporate Taxation
Submitted To The
COMMITTEE ON FINANCE
UNITED STATES SENATE
November 7, 1983

Mr. Chairman and members of the Committee:

This statement by the Coalition for Low and Moderate Income Housing will address the question, raised in the Press Release of October 4, whether limited partnerships with publicly traded partnership interests should be taxed as corporations.

The Coalition for Low and Moderate Income Housing brings together in a single coalition all associations, trade groups, business organizations, and individuals, as well as associated professionals, involved in the private financing, production, rehabilitation and operation of government assisted low and moderate income multi-family rental housing. The Coalition works with the Administration, Congress, state governments and others in an effort to promote the financing, production, rehabilitation and operation through private enterprise of low and moderate income housing in the most effective ways possible. It is constantly seeking new and better methods for accomplishing that objective.

There are several important reasons of public policy for not according corporation treatment to partnerships which invest in real estate or otherwise provide financing for real estate. These reasons include the structure of the investment market for real estate, protection of small investors and Congress' encouragement of pension fund diversification.

The Investment Market for Real Estate.

As you already know, there has been a great shortage of multi-family rental housing for families and individuals of low and moderate income for many years, and that shortage continues unabated today. A copy of a recent article in the Washington Post discussing this nationwide problem is attached for your information.

When Congress enacted the Economic Recovery Tax Act of 1981, it recognized that an adequate supply of housing, and other productive real estate, is created only by private investment. Congress, therefore, enacted specific tax incentives to encourage private investment in real estate, and especially in housing -- an investment which creates new jobs, revitalizes urban areas, and provides shelter at a fair price for millions of Americans.

Real estate investments must be made through partnerships in order for such investments to be economically viable in the marketplace. Typically, the rents and other items of current income from a real estate investment are exceeded by the expenses of the investment, including debt service. Thus, such investments normally are economic only if the investors can take advantage of the tax incentives enacted by Congress, including the deduction for accelerated depreciation. The tax incentives to invest in real estate are not available to individual investors if the real estate is held in the corporate form. Accordingly, in order for capital to continue to be attracted into real estate investments on a large scale, it is absolutely necessary that real estate investments be permitted to be made through partnerships.

Small Investor Participation.

The staff's proposal to tax publicly traded partnerships as corporations, if applied to partnerships investing in or financing real estate, fails to take into account the fact that the tax effects of an investment in real estate do not depend on the number of investors. For example, if a partnership of two persons invests in an office building, the tax deductions will be the same as would be with a partnership of 200 persons. The total income or loss from the investment will depend only on the property, not on the number of investors. The same is true if the 200 investors can freely transfer their interests. The overall taxable income or loss remains the same; it is merely spread over more partners.

Recently, larger limited partnerships have been formed for small investors. Typically, one of these partnerships will purchase a number of real estate properties of a specific type for the particular combination of ongoing economic, including tax, benefits and long-term appreciation. They hold these properties in a similar fashion to the way individuals hold these assets -- namely, they hire professional managers to manage the buildings and collect rents, and they hold the property for its long-term appreciation.

The formation of these large real estate partnerships are intended merely to secure the same economic and tax benefits that large investors have traditionally enjoyed with real estate. These partnerships are not operated like manufacturing or sales companies; they derive their income and appreciation from professional management of the real estate properties which they own.

Similarly, large partnerships may be formed to hold mortgages on real estate properties. The debt interests owned by these partnerships are no different from those owned by individual investors who buy mortgages. The large public partnerships merely allow small investors to invest in these debt instruments in a diversified fashion.

Considerations of fairness should dictate that small investors not be foreclosed from investing in real estate along with large investors which have traditionally been part of this investment market. These investors should not be penalized by having their partnerships taxed as corporations when the partnerships have only engaged in the type of activities in which large investors could individually engage.

Pension Fund Diversification.

When Congress enacted the Employee Retirement Income Security Act of 1974, it recognized that employee pension funds should be allowed and encouraged to diversify their investments, including investments in real estate. In 1979 the Department of Labor proposed rules to allow pension funds to do this and still provide for adequate liquidity. The Proposed Regulations, 44 F.R. 168 (August 28, 1979) provide that where pension funds invest in partnerships or corporations which are "publicly traded, freely transferable and widely held, as in the case, for example, of some real estate investment trusts (REITS's)," they will not be deemed to be "plan assets" (which means that the management of the corporation or partnership will not be fiduciaries of the pension plan). In promulgating this Proposed Regulation, the intent was to allow pension funds to invest in these "pooled investment vehicles" (as opposed to an operating company) without causing new ERISA responsibilities for the publicly traded corporation or partnership.

Pension funds are required to seek investments with sufficient liquidity and diversification to protect their beneficiaries. In order for these funds to invest in partnerships which own real estate and comply with these proposed regulations, the partnerships will have to be publicly traded. Otherwise pension funds will lose a valuable investment medium. In addition, since pension fund fiduciaries are required to periodically report on the fund values to their beneficiaries, it is desirable for their interests in real estate partnershps to be freely traded on the open market. This option for pension funds of investing in real estate through the use of publicly traded partnerships should not be foreclosed by the adoption of a tax on these partnerships.

For the reasons discussed above, the Coalition believes that it would not be advisable to tax partnerships which hold equity or debt interests in real estate as corporations. Instead, the staff's proposal should focus on those partnerships which have taken operating businesses normally run by corporations and "dis-incorporated" them; the proposal should not include investments in real estate which have traditionally been owned by partnerships or individuals.

Martin C. Schwartzberg
Chairman

The Washington Post REAL ESTATE

Saturday, November 5, 1983

Apartment Crunch Foreseen for Nation, Washington Area

Lower-Income People Face Severe Squeeze

By Ann Mariano
Washington Post Staff Writer

More and more Americans will need rental housing in the coming years as high interest rates and housing costs shut them out of homeownership. At the same time, the supply of rental houses and apartments is expected to dwindle and deteriorate.

The Washington area is likely to be among the hardest hit by this crunch. The squeeze is already being felt, particularly in the District of Columbia, where condominium conversions, high costs and rent control statutes have sharply reduced the number of rental apartments, according to industry analysts.

Poor and moderate-income families suffer the worst. Maryland developer James W. Rouse, citing "needs of the people in this country that aren't being met," believes there is a critical shortage of adequate housing for this segment of the population.

He quoted 1980 census figures that showed 9 million families with incomes of less than $7,000 a year are renters and spend 44 percent of their income on the rent.

"We've got to have federal aid, but something's got to work more effectively than it has in the past," Rouse added.

Rouse, noted for rehabilitating crumbling inner-city areas, such as Baltimore's Harbor Place, and planned communities like Columbia, said the federal government is "stepping back" from helping the poor "and a vacuum is left."

A little-noticed statistic, he said, is that "there are now $250 billion in unfunded federal obligations for housing. This is payments yet to be made on Section 8 (subsidized housing), payments yet to be made on credit subsidies, payments yet to be made by the federal government for support we've given to housing that exists." That sum, he added, "doesn't appear in any balance sheet anywhere."

In the Washington area, as in other sections of the country, escalating costs of land and construction have outdistanced rent levels, forcing many small-scale developers out of rental construction. Those who remain still make up the majority of landlords, however. They, as well as the big, national development companies, depend heavily on tax-exempt financing to keep their rents affordable.

"The problem quite simply is that the numbers generally don't work without direct or indirect subsidies," according to William D. Comings Jr. of Washington, an executive of the National Corp. for Housing Partnerships. The company is the second largest apartment owner/management firm in the nation, according to a California accounting firm, Kenneth Leventhal & Co.

Thomas Bozzuto, regional head of The Oxford Group here, said the "development of apartments in most parts of the United States would be virtually impossible without tax-exempt financing," including the Washington metropolitan area." Bozzuto's firm, headquartered in

Bethesda, is building four rental apartment complexes in suburban Maryland and Virginia.

Under the most widely used vehicle, developers are eligible for tax-exempt financing if they rent 20 percent of the units they build to moderate income households. To qualify, families must have incomes lower than 80 percent of the median income—or $26,000 for a family of four in the Washington area.

Builders using this type of financing are prohibited from converting units to apartments for 10 years. As a consequence, some developers use this type of financing to construct buildings already equipped for eventual conversion but rent out the units for 10 years to get maximum tax benefits, said a municipal housing agency worker.

A congressional effort to curtail this tax-free financing has sent shock waves through the housing industry and local government agencies charged with housing the poor. Both groups say they fear that without the below-market interest rates made possible by this type of funding, construction of rental housing for all but the most affluent will be brought to a near-standstill.

Rental apartments are already scarce for low- and moderate-income residents here. Vacancy rates in the metropolitan Washington area range from 3 to 3½ percent, according to Donald R. Slatton, executive vice president of the Apartment and Office Building Association.

"The rental housing market is getting worse and worse, and more and more buildings are going into foreclosure," especially in the District, Slatton said. He blames city rent control laws, cumbersome requirements for condominium conversions, and delays of "five to eight months to evict tenants who are not paying the rent."

Rent control is effective in the short run in keeping rents within reach of low- and moderate-income tenants. In the long run, however, "the continuation of rent controls only increases the shortage of rental housing and the deterioration of the existing rental inventory," according to a study by rental housing across the nation by Anthony Downs, a senior fellow in economic studies for the Brookings Institution in Washington. "The gap between existing rents and those needed to make construction of new rental units economically feasible rises continuously" while controls are in effect, he added.

Slatton said there "is a much better business climate for landlords" in the Maryland and Virginia suburbs. Rental construction under way is taking place in the suburbs and "the nicer buildings are there," he said.

A recent survey of rental apartments in Montgomery County showed that vacancy rates have declined over the past year and a half, indicating a scarcity of available units. The study was done by the county's Office of Landlord-Tenant Affairs.

"It is clear . . . that the rental market has tightened considerably . . . ," noted a report of the survey findings. "It is also clear that families who are unable to pay more than $350 per month for a one-bedroom unit or $400 per month for a two-bedroom unit will have great difficulty finding a home."

Low vacancy rates—around 1 percent—also are reported in Alexandria. The city faces a shortage of rental apartments that "is growing much worse," said Mark Looney, landlord-tenant administrator for the city.

Condominium conversions have taken many apartment buildings out of the rental market in the metropolitan area. Condo sales have been slow during the recession, however, and some units were returned to the rental market while owners wait and hope for a pickup in sales. Rents on these apartments, however, generally are too high for moderate-income families.

The one exception to the general decline in apartment construction has been the Sun Belt where lower construction costs and booming population growth lured developers into what now turns out to have been a spree of overbuilding.

"Texas, Oklahoma and Louisiana, for example, had lucrative energy businesses to stabilize their economies during the recession, so investors flocked to those states, building multifamily units to accommodate the expected continuing influx of new residents," said Michael Carliner, director of housing forecasting for Chase Econometrics. Now, with oil prices on the decline, "unemployment is rising in those states, making the demand for new and partially completed apartments and condos very low."

"The continuation of rent controls only increases the shortage of rental housing and the deterioration of the existing rental inventory," according to Anthony Downs of Brookings.

Back in mid-1982, high occupancy rates in Sun Belt apartments, rising rents and available financing combined to lure many builders into apartment construction, according to G. Ronald Witten, head of M/PF Research, Inc. in Dallas. Money from mortgage subsidy bonds and industrial development bonds, with federal or municipal backing, came with "quite attractive" rates around 10 and 11 percent, he said.

The office and light industrial markets were overbuilt by this time, and "developers . . . flocked to apartments as the hottest new game in town," said Witten. "Some of them never built apartments [before] in their lives."

Another element in the Texas apartment building boom has been a new role for lenders as joint venture partners with developers.

Savings and loan institutions saddled with portfolios of low-interest-rate mortgages were eager "to diversify from single family homes and apartments seemed to be a simple transition," Witten said.

These new partnerships "are a little incestuous," but initially effective, he said. The boom is producing an oversupply in part because "of the changed relationship between developer and lender, which was so important in keeping the market in check."

Construction started on 20,000 units in the first half of this year in the Dallas area, more than the entire total of 18,000 started in 1982. The 18-month total of 38,000 represents a four-year supply of apartments for the area, said Witten.

The oversupply of rental units can be a boon to tenants by holding down rents in the future, Witten said.

Tenants in most other areas of the country will not be so fortunate. Rents can be expected to remain high, while less aid can be expected from the federal government.

Developer Rouse believes he has one answer. He is a proponent of neighborhood-based, self-help organizations such as Jubilee Housing, which he helped found 10 years ago in the Adams-Morgan section of the District. The Enterprise Foundation, another Rouse creation, is raising $25 million to aid non-profit housing groups in other cities, he said.

Statement of

ARTHUR J. GARTLAND
Managing Director
DEAN WITTER REYNOLDS INC.
130 Liberty Street
New York, N. Y. 10006

This statement relates to hearings held on October 24, 1983 before the Committee on Finance of the United States Senate (the "Committee") concerning certain aspects of the Preliminary Report prepared by the Committee Staff on The Reform and Simplification of the Income Taxation of Corporations.

PROPOSED LEGISLATION

The Committee Staff, in a preliminary report dated September 22, 1983 and entitled "The Reform and Simplification of the Income Taxation of Corporations", has proposed enactment of certain changes in law affecting the tax treatment of corporate dividends. These include the following:

1. Denial of deductibility on 85% of interest expense incurred on debt used to purchase or carry stocks paying dividends eligible for the 85% inter-corporate dividends exclusion.
2. Extension of the present holding period to establish eligibility to claim the 85% inter-corporate dividends exclusion from fifteen days to one year.

These changes are proposed to apply to stock "acquired" and interest "accruing" after December 31, 1983.

EFFECT OF PROPOSALS IF ENACTED

If the above proposals are enacted as proposed, they can be expected to:

1. Have a devastating impact on the capital markets, especially the market for preferred stocks;

2. Lead to significantly greater use of debt financing by corporations and less equity financing;
3. Lead to a further concentration of U. S. industry; and
4. Reduce (rather than increase) tax revenues received by the U. S. Treasury.

RATIONALE FOR PROPOSALS

1. Simultaneous Availability of 85% Dividends Exclusion and Deductibility of Interest - It has come to the attention of the Committee (by reason of a 1982 submission from the New York State Bar Association) that a corporation may reduce its income taxes by investing in preferred and/or high yield common stocks while using debt to partially fund its investment. The investing corporation reports 15% of dividends received as income, but deducts 100% of interest paid, and thereby generates tax "losses" which can be used to offset other income.

2. Minimum Holding Period - This issue arose because at least some companies are setting up a tax arbitrage (not unlike a commodity straddle) whereby a stock is purchased shortly before its ex-dividend date and another stock with very similar attributes is simultaneously sold short for delivery just after its ex-dividend date. The "loss" on the short-sale is almost exactly equal to the dividend received on the stock held "long". In effect, dividend income subject to the 85% exclusion is generated, while at the same time nearly identical ordinary losses are produced. With almost no money at risk, the investing corporation generates tax losses equal to approximately 85% of anticipated dividends/matching losses.

REAL EFFECT OF LEVERAGED STOCK ACQUISITIONS

In formulating its proposal to deny deductibility of 85% of interest incurred on debt used to purchase or carry dividend paying stocks, the Committee Staff has attacked a "problem" which, in fact, does not really exist. There is no appreciable revenue loss to the U. S. Treasury, on an overall basis, because of the leveraging of inter-corporate stock investments. Indeed, the ability to use leverage has helped to make the cost of equity financing more competitive than would otherwise have been the case, and has made non-control inter-corporate equity investments viable economically. To that extent, it has helped to encourage the raising of equity, which, in turn, has led to greater tax revenues. That is because corporate profits are subject to double taxation. More equity leads to more corporate profits and, in turn, to greater tax revenues.

The Committee Staff unfortunately has focused its attention on just one small part of a rather long equation. A corporation which invests in stock, and which uses any significant amount of debt in its capital structure, will unavoidably reduce its own income taxes as a consequence of such combined factors. This has been the case for over 40 years and is not a "problem", due to the following factors:

1. "Dividends", in most cases, represent income already fully taxed. (This is overwhelmingly the case with preferred stock dividends.) In non-control situations (i.e., where stock holdings are not great enough to allow tax consolidation), there is simply a shifting (and not an avoidance) of the income tax burden. Our tax system stipulates that the first corporation generating income (i.e., the issuer of stock) pay the full tax prior to distribution of profits (i.e., dividends). The use of leverage by the investing corporation produces a slightly smaller "loss" in tax revenues than would have occurred had the issuer of stock itself incurred the debt used by the investing corporation.

2. A corporation using debt to partially fund acquisitions of stock will increase its net income, which, in turn, will ultimately lead to greater fully-taxable dividends to its own shareholders, reversing much of the tax savings enjoyed by the corporation.

3. The corporation's interest deductions are exactly equal in amount to the lender's taxable income. Most lenders (i.e., banks, life insurance companies, casualty insurance companies and individuals) are taxable entities. Even in the case of tax-exempt lenders (i.e., pension funds), the beneficiaries ultimately pay tax on interest earned. This further reverses any tax reduction which initially occurs. (Taxable lending intermediaries also introduce another opportunity for double taxation as they too pay dividends.)

4. Using debt to buy stock is not analogous to using debt to buy tax-exempt securities. Dividends are not tax-exempt, but rather are fully taxed prior to distribution. The

Treasury gains nothing from promoting lower tax-exempt rates. It does stand to gain from promoting more equity financing. It stands to lose revenues if it discourages equity financing.

The actual fact is that leveraged, non-control, intercorporate equity investments produce more tax revenues overall than almost any other form of financing. Oddly enough, the Committee Staff proposals would force corporations to choose precisely those financing methods which would tend to produce significantly less tax revenue overall.

EXAMPLES

Corporation A needs to raise $1,000,000 to invest in its business. It would like to issue preferred or common stock, but would consider issuing subordinated debt instead if it were less costly. It finds it has the following financing alternatives:

1. Corporation A can issue $1,000,000 in non-control preferred stock, paying dividends at 10%, to Corporation B. To fund its purchase, Corporation B will borrow $750,000 from (taxable) Lender C, agreeing to pay 12% interest, and will use $250,000 of its own equity as well.
2. Corporation A can issue $1,000,000 in subordinated notes to Corporation B, agreeing to pay 17.24071% interest. (This "interest" rate is exactly equal to the pre-tax equivalent of a 10% "dividend" rate.) To fund its purchase of notes, Corporation B will borrow $750,000 from Lender C at a 12% interest rate and will use $250,000 of its own equity.
3. Corporation A can issue $1,000,000 of control common stock to Corporation B. To fund its purchase, Corporation B will borrow $750,000 from Lender C at 12% interest and will use $250,000 of its own equity.
4. Corporation A can sell $1,000,000 of its subordinated notes to a tax-exempt pension fund. Again, the interest rate payable by Corporation A would be 17.24071%.

Note: Each of the above financing techniques is commonly utilized, and while other alternatives are possible, it is very unlikely that Corporation A could issue all its stock, preferred or common, to unleveraged corporations or unleveraged individuals. That is because (a) an unleveraged corporation would not logically bid as high a price as a leveraged corporation and there are very few corporations which have no debt, and (b) individuals having a 25% tax rate or higher would enjoy a higher yield and less risk by buying taxable or tax-exempt debt rather than dividend paying (non-rapid growth) stocks.

Assume:

a) Corporation A's marginal tax rate is 46%.
b) Corporation B's marginal tax rate is 46%.
c) Lender C's marginal rax rate is 20%.
d) Common shareholders of A, B and C pay tax at an "average" rate of 25% (blends 20% capital gain rate and assumed rate of 30% for ordinary income).
e) Corporation A generates $200,000 in annual income from its new asset before interest, taxes and dividends.

The tax revenues to be collected by the U. S. Treasury given each of the above alternatives would be as follows (see attached flow charts also):

Alternative	Total Tax	Portion Deferrable
(1)	$ 106,625.00	$ 31,125.00
(2)	$ 101,450.00	$ 32,850.00
(3)	$ 101,450.00	$ 32,850.00
(4)	$ 59,519.44	$ 46,827.85

It seems very strange that the Committee Staff proposes to effectively do away with Alternative (1), while preserving the others, especially when a stated goal is to increase tax revenues. If the Staff proposal is enacted into law, dividend rates will have to rise and/or stock prices will have to fall to maintain yields. This will raise the cost of equity and encourage companies to use more debt in place of it. As can be seen from the above example, the surest way to reduce tax revenues is to encourage the greater use of debt. That is precisely what will occur, however, if the Staff proposals are adopted.

The Staff proposals, if enacted, would also encourage control equity investments by making non-control equity investments largely uneconomic. Control companies could still incur debt and invest such debt in the stocks of its subsidiaries. Unless individuals could supply all equity needs, which is unrealistic, more and more corporations would have to merge to obtain requisite equity funds. Financing conglomerates would quite literally be compelled by tax effects. This could hardly be viewed as a positive development. As indicated in Alternative (3), it would also lower tax revenues.

A final point is also worth making. In the above example, the 10% preferred stock had a higher after-tax cost to Corporation A than 17.24% debt because of the non-deductibility of dividends. This illustrates that our tax system already strongly encourages debt financing rather than the use of equity. The Staff's proposal, if enacted, can only serve to accelerate this trend since it would increase the cost of equity even more.

THE "CHRYSLER PROBLEM"

In private conversations with the author and others, the Staff has expressed a general sense that if dividends paid do really represent already fully taxed distributions, then the use of leverage is probably not detrimental. However, concern has been expressed that "many" companies may not be paying current tax, but still pay dividends eligible for the 85% exclusion. To the extent the stocks of such companies were leveraged, there would be a net outflow from the U. S. Treasury. Chrysler Corporation, in relation to its preferred stock dividend, was cited as the most visible example of this phenomenon.

In point of fact, some companies did pay less current tax in 1982 than their preferred dividends, Chrysler being one of them. However, such companies are in the minority. And, on an aggregate basis, current tax paid in 1982 by U. S. corporations overwhelmingly exceeded their preferred stock dividends, making it plain that such dividends do in fact in the aggregate represent distributions of fully-taxed income.

In order to get a sense of whether there were many companies not paying tax in an amount at least equal to their preferred stock dividends, the author looked at the 1,000 largest companies, in terms of sales, whose common stocks are listed on the New York or American Stock Exchanges or traded "over-the-counter". The source of basic information was the "Compustat" data base, which is compiled by Standard & Poor's Corporation. The basic finding of that investigation was that those companies with preferred stock outstanding paid current taxes in 1982 of approximately $14.14 billion compared to preferred dividends aggregating only $2.02 billion. Thus, there is little question that those dividends were fully-taxed distributions.

It is perhaps also worthy to note that few companies are probably willing to leverage a stock such as Chrysler. That is because using leverage increases risk (i.e., the dividend might not be paid, but interest would still be due). It makes little sense to add extra risk to an already rather risky investment.

In conclusion, the author believes the Staff's concern over the "Chrysler" phenomenon is not supported by the facts and is, therefore, invalid. Our tax laws need to be based on the overall situation, not on the odd case.

EFFECT ON CAPITAL MARKETS IF ENACTED

The Staff proposes in its Preliminary Report that denial of deductibility would apply to interest "accruing" after December 31, 1983. All existing investments where leverage is employed would thereby be affected and, thus, there would be no effective "grandfathering". That is because, unless all such leverage is immediately repaid, interest will continue to accrue after December 31.

Even on a fully "grandfathered" basis, the Staff proposal makes little sense as it will lead to lower tax revenues in the long-term. If enacted without grandfathering, however, it would have a devastating impact on the capital markets, would result in very significant trading losses and would result in a large near-term reduction in tax revenues.

In Alternative (1) above, Corporation B's after-tax yield on investment was 17.8% (i.e., $44,500 in net income on a net equity investment of $250,000). If Corporation B could only deduct 15% of its interest expense, however, its after-tax yield would precipitously fall to only 3.724%, or hardly enough to justify the investment. It, along with all other companies using leverage, would be forced to sell their entire stock holdings as rapidly as possible into a market where the only potential buyers would be either (a) unleveraged corporations (a small universe), or (b) individuals who do not enjoy the dividends exclusion. The result would be massive trading losses which would reduce tax revenues. Such losses would also not endear the sponsors of the legislation to the corporations (and their shareholders) which just experienced the losses.

There is probably in excess of $50 billion of preferred stock outstanding. Most preferred stock, and a lesser percentage of common stocks, are presently held by corporations. In turn, most corporations (especially financially-oriented ones) use substantial debt as part of their capital structures. Today's market yields fully reflect the ability to use leverage which has been regularly practiced for over 40 years since the intercorporate exclusion was enacted. In order to attract buyers, barring the ability to deduct interest, stock prices might literally have to fall by up to 40% from current levels. Thus, the magnitude of the problem that would be caused is very substantial. Again, the proposal now before the Committee makes no sense. It would create a major problem where no real problem now even exists.

EXTENSION OF PRESENT HOLDING PERIOD

The Staff proposal to extend the holding period from fifteen days to one year would hurt all non-control corporate investors to solve a tax abuse being practiced, almost certainly, by less than one-half of one percent of corporate investors. The proposal will particularly effect buyers of adjustable rate preferred stocks ("ARPS") who bought such securities on the specific premise of liquidity. This new instrument has been almost solely responsible for major banks' recently being able to bolster their equity positions, as specifically requested by the Federal Reserve. To do so they needed permanent (i.e., perpetual) equity at a reasonable cost. ARPS was the only way to get adequate funds as it allowed banks (and others) to tap the corporate market, which but for ARPS would not have been feasible. If the holding period is extended to one year, liquidity for all intents and purposes will be lost, which in turn will result in substantial losses. The author believes on the order of $7 billion of ARPS have been issued during the past 18 months.

The author sympathizes with the Staff conclusion that some change in law is necessary to preclude the type of "tax arbitrage" previously described. The author agrees that this is an instance of tax abuse. However, the approach taken by the Staff would be much too far reaching in its impact to be justified. The author strongly believes that the same result could be achieved (i.e., stopping this specific abuse) if the definition of "substantially identical" stock were broadened. This was essentially the approach taken in curtailing commodity straddles. Some minor extension of the holding period, to perhaps thirty days, might also be warranted. However, extending the holding period to one year is clearly unwarranted by the facts, especially when more reasonable solutions are possible.

ATTACHMENTS

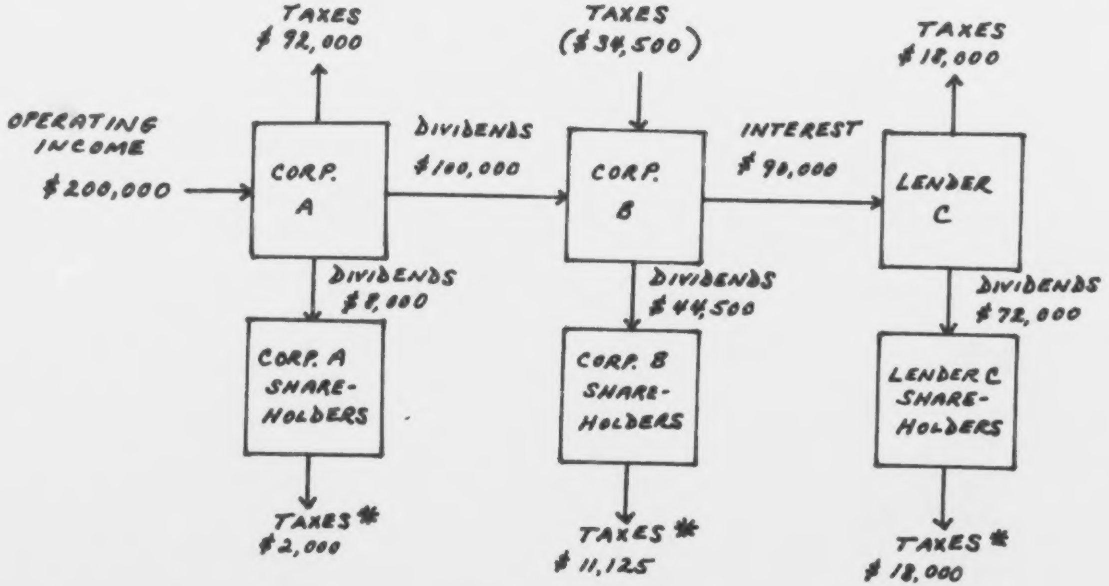
Attached to this statement are illustrations of the tax flows to the U. S. Treasury under the financing alternatives described above. The author believes such revenue flows have been computed accurately. Also attached are copies of the computer printouts obtained by the author in researching the relationship between current corporate taxes in 1982 and preferred stock dividends. Companies crossed-out were deleted by the author in computing aggregate results as they primarily do business outside of the United States. Thus, their current tax likely represents, in large part, taxes paid to foreign governments.

THE AUTHOR

The author is a Director of Dean Witter Reynolds Inc. ("DWR"), which is one of the largest securities brokerage and investment banking firms in the United States. He is also Manager of DWR's Private Finance Group. In such capacity, the author has primary responsibility within DWR for the firm's activities in the private (i.e., unregistered) placement of debt and equity securities, project financing and leasing. During the preceding four years, DWR has been responsible for in excess of $6 billion of private financing, including over $1 billion in privately placed preferred stock.

ALTERNATIVE #1 - 10% PREFERRED STOCK LEVERAGED WITH 12% DEBT

TOTAL TAXES = $106,625 / DEFERRABLE PORTION = $31,125


TAXES
$92,000
TAXES
($34,500)
TAXES
$18,000
OPERATING
INCOME
$200,000
CORP.
A
DIVIDENDS
$100,000
CORP.
B
INTEREST
$90,000
LENDER
C
DIVIDENDS
$8,000
DIVIDENDS
$44,500
DIVIDENDS
$72,000
CORP. A
SHARE-
HOLDERS
CORP. B
SHARE-
HOLDERS
LENDER C
SHARE-
HOLDERS
TAXES *
$2,000
TAXES *
$11,125
TAXES *
$18,000

(*) TAX DEFERRED TO EXTENT DIVIDENDS ARE LESS THAN 100% OF NET INCOME

Oct 19, 1983 . 10:23 Page 1

Ticker	Company Name	SALES	INCOME TAX PAYABLE	PREFERRED DIVIDENDS
GM	GENERAL MOTORS CORP	60025.617	0.000	12.900
C	CHRYSLER CORP	10044.902	5.600	29.100
AXP	AMERICAN EXPRESS	8093.000	0.000	1.000
HI	HOUSEHOLD INTERNATIO	7767.500	0.000	27.400
GD	GENERAL DYNAMICS COR	6154.500	0.000	2.500
GP	GEORGIA-PACIFIC CORP	5402.000	5.000	15.000
AMR	AMR CORP-DEL	4176.972	0.000	12.033
ALD1	BENDIX CORP	4112.597	2.300	16.700
ICX	IC INDUSTRIES INC	3867.901	16.000	19.700
1900B	AGWAY INC	3832.978	0.000	4.338
EAL	EASTERN AIR LINES	3769.237	0.000	19.993
TL	TIME INC	3564.328	12.050	16.962
GR	GOODRICH (B.F.) CO	3005.301	0.900	9.900
AMO	AMERICAN MOTORS CORP	2878.416	0.000	8.897
ASN	ALCO STANDARD CORP	2851.998	1.315	2.062
AG	ALLEGHENY INTERNATIO	2838.619	15.947	45.045
ESM1	NORTON SIMON INC	2679.251	7.301	16.685
WIX	WICKES COS INC	2638.214	0.000	0.492
CBE	COOPER INDUSTRIES IN	2394.629	14.378	15.961
~~ALI~~	~~ALUMINUM CO OF CANAD~~	~~2367.000~~	~~0.000~~	~~29.000~~
OG	OGDEN CORP	2202.243	(5.643)	0.699
~~MSE~~	~~MASSEY FERGUSON LTD~~	~~2066.101~~	~~5.800~~	~~40.100~~
GQ	GRUMMAN CORP	2003.243	1.678	5.609
WSW	WHITE CONSOLIDATED I	1989.562	2.130	3.704
GE1	GENERAL ELECTRIC CRE	1938.550	0.000	6.800
VLO	VALERO ENERGY CORP	1901.131	0.000	9.775
PEL2	TRUNKLINE GAS CO	1802.218	0.000	1.716
CNP.A	CROWN CENTRAL PETROL	1772.467	0.000	1.279
1219A	MCCRORY CORP	1740.781	0.000	0.845
JR	JAMES RIVER CORP OF	1656.112	0.000	3.881
AH	ALLIS-CHALMERS CORP	1609.992	5.854	11.250
NSC1	SOUTHERN RAILWAY	1603.597	2.079	2.852
KOP	KOPPERS CO	1585.206	4.485	8.100
~~MMB~~	~~MACMILLAN BLOEDEL LT~~	~~1498.400~~	~~5.400~~	~~16.200~~
BNL	BENEFICIAL CORP	1440.000	0.000	17.200
HML	HAMMERMILL PAPER CO	1395.950	0.070	3.890
GST	GENSTAR CORP	1388.365	(16.459)	15.194
AR	ASARCO INC	1350.695	17.994	18.663
2982B	ABITIBI PRICE INC	1328.655	7.423	8.784
2981A	STROH BREWERY CO	1317.986	0.000	0.015
WIT	WITCO CHEMICAL CORP	1305.418	0.000	0.118
U	USAIR GROUP	1273.012	0.000	0.355
FOOD	FIRST NATIONAL SUPER	1267.563	0.000	0.032
~~HYO~~	~~HUSKY OIL LTD~~	~~1249.406~~	~~0.000~~	~~4.259~~
EVY	EVANS PRODUCTS CO	1237.906	0.000	4.890
~~N~~	~~INCO LTD~~	~~1235.903~~	~~3.600~~	~~20.053~~
PRIN	PACIFIC RESOURCES IN	1234.809	0.000	0.672
CULL	CULLUM COS	1126.638	0.000	0.002
UVV	UNIVERSAL LEAF TOBAC	1081.903	0.000	0.013
WAL	WESTERN AIR LINES IN	1065.270	0.000	2.394
WU	WESTERN UNION CORP	1024.950	0.000	8.310
FDX	FEDERAL EXPRESS CORP	1008.087	0.372	0.872

U.S. COMPANIES WHICH PAID LESS
CURRENT TAX THAN THEIR PREFERRED
STOCK DIVIDENDS IN 1982

Oct 19, 1983 10:23

Page 2

Ticker	Company Name	SALES	INCOME TAX PAYABLE	PREFERRED DIVIDENDS
CRO	CHROMALLOY AMERICAN	973.594	0.000	4.065
GMT	GATX CORP	951.400	0.000	0.600
PPR	PANTRY PRIDE INC	945.783	0.000	5.536
WUI	WESTERN UNION TELEGR	931.849	0.000	10.115
HLR	HELLER (WALTER E.) I	886.125	0.000	0.338
CYL	CYCLOPS CORP	873.165	0.000	0.453
LCE	LONE STAR INDUSTRIES	866.755	1.500	14.166
PCH	POTLATCH CORP	820.180	2.884	9.281
RCI	REICHHOLD CHEMICALS	814.911	1.074	2.944
CRN	CARSON PIRIE SCOTT &	797.624	0.600	2.200
BLT.B	BLOUNT INC-CL B	788.733	0.000	1.198
GCO	GENESCO INC	664.805	0.000	2.243
CCF	COOK UNITED INC	646.001	0.000	0.069
DLJ	DONALDSON, LUFKIN &	628.667	0.000	2.090
GAF	GAF CORP	623.236	1.392	2.980
1366B	EARLY & DANIEL INDS	605.275	0.000	0.111
ASU	ALLIED SUPERMARKETS	603.358	0.000	0.168
KAB	KANEB SERVICES INC	595.617	1.424	2.020
SWF	SOUTHWEST FOREST IND	575.945	0.151	6.300
RHR	ROHR INDUSTRIES	565.880	0.788	3.398
ABA	AMERICAN BAKERIES CO	526.783	0.133	0.177
MFS	MOUNTAIN FUEL SUPPLY	510.340	0.000	5.360
FBO	FEDERAL PAPER BOARD	509.987	0.000	0.474
SHG	SHELLER-GLOBE	500.171	1.116	2.063
76	*** TOTALS ***	*****.***	~~126.634~~	~~610.543~~
	*** AVERAGES ***	~~2728.492~~	~~1.666~~	~~8.033~~
71			111.746	492.931
OK		2802.205	1.57389	6.94269

Oct 19, 1983 10:32 Page 1

TAXES PAYABLE GREATER THAN PREFERRED DIVIDENDS

Ticker	Company Name	SALES	INCOME TAX PAYABLE	PREFERRED DIVIDENDS
T	AMERICAN TELE & TELE	65093.019	1669.300	141.900
~~BP~~	~~BRITISH PETROLEUM PL~~	~~47524.011~~	~~869.000~~	~~1.000~~*
~~RD~~	~~ROYAL DUTCH PETE-NY~~	~~46249.011~~	~~1209.000~~	0.023*
DD	DU PONT (E.I.) DE NE	33331.007	334.000	10.000
~~SC~~	~~SHELL TRANSPORT & TR~~	~~30833.007~~	~~886.000~~	1.000*
ARC	ATLANTIC RICHFIELD C	26462.207	117.107	10.532
X	U S STEEL CORP	18375.003	168.000	22.000
OXY	OCCIDENTAL PETROLEUM	18212.203	581.746	89.209
ITT	INTL TELEPHONE & TEL	15958.402	420.953	41.018
SUN	SUN CO INC	15519.003	275.000	3.000
TGT	TENNECO INC	14979.003	113.000	62.000
UTX	UNITED TECHNOLOGIES	13577.101	101.032	69.570
~~UN~~	~~UNILEVER N V~~	~~12507.000~~	~~194.000~~	~~5.600~~*
PG	PROCTER & GAMBLE CO	12452.000	275.000	0.012
GTE	GTE CORP	12066.402	527.235	30.196
GET	GETTY OIL CO	11970.703	747.450	0.878
~~IMP~~	~~IMPERIAL CHEM INDS P~~	~~11909.203~~	~~228.100~~	~~0.500~~*
KR	KROGER CO	11901.902	20.078	4.500
RJR	REYNOLDS (R.J.) INDS	10906.000	242.000	36.000
CP	CANADIAN PACIFIC LTD	9991.351	120.265	1.337*
WX	WESTINGHOUSE ELECTRI	9745.402	246.300	0.600
BRY	BEATRICE FOODS CO	9188.199	118.300	16.800
ASH	ASHLAND OIL INC	8864.667	42.643	35.532
~~UL~~	~~UNILEVER PLC-AMER SH~~	~~8770.000~~	~~161.000~~	~~0.403~~*
AHC	AMERADA HESS CORP	8342.566	322.808	1.939
RCA	RCA CORP	8237.000	165.400	68.900
LKS	LUCKY STORES INC	7972.972	45.521	1.374
T22	PACIFIC TEL & TEL CO	7855.500	233.900	47.600
ASC	AMERICAN STORES CO-N	7507.769	31.738	11.220
ROK	ROCKWELL INTERNATION	7395.398	28.200	1.600
GM1	GENERAL MOTORS ACCEP	7255.398	357.600	7.000
~~BCA~~	~~BELL CANADA ENTERPRI~~	~~6838.398~~	~~132.600~~	~~45.000~~*
MTC	MONSANTO CO	6325.000	123.000	0.300
ALD	ALLIED CORP	6167.000	236.000	68.000
GRA	GRACE (W.R.) & CO	6127.601	97.000	0.700
CFD	CONSOLIDATED FOODS C	6039.273	7.953	3.226
NB	NABISCO BRANDS INC	5871.101	58.100	0.400
CGP	COASTAL CORP	5799.410	8.867	8.035
CNV	CITY INVESTING CO	5771.101	14.800	3.700
DH	DAYTON-HUDSON CORP	5660.726	92.457	0.061
LK	LOCKHEED CORP	5613.000	28.800	3.300
JWL	JEWEL COS INC	5571.718	16.825	8.886
AS	ARMCO INC	5427.898	123.200	3.600
GW	GULF & WESTERN INDS	5331.480	49.643	7.043
UAL	UAL INC	5319.707	8.482	0.348
TRW	TRW INC	5131.871	38.487	5.708
Z	WOOLWORTH (F.W.) CO	5124.000	21.000	2.000
TW	TRANS WORLD CORP	5107.859	31.763	24.846
CCC	CONTINENTAL GROUP	4979.000	74.500	23.600
LIT	LITTON INDUSTRIES IN	4932.609	59.231	4.065
CL	COLGATE-PALMOLIVE CO	4887.992	98.301	0.440

U.S. COMPANIES WHICH PAID MORE CURRENT TAX THAN THEIR PREFERRED STOCK DIVIDENDS IN 1982

SOURCE: COMPUSTAT DATA BASE
STANDARD & POOR'S CORPORATION

TAXES PAYABLE GREATER THAN PREFERRED DIVIDENDS

Ticker	Company Name	SALES	INCOME TAX PAYABLE	PREFERRED DIVIDENDS
LTV	LTV CORP	4776.800	49.000	1.428
AA	ALUMINUM CO OF AMERI	4647.597	60.700	2.500
AMP	AMERICAN HOME PRODUC	4582.093	94.147	0.320
G	GREYHOUND CORP	4525.605	43.673	0.285
HR	INTL HARVESTER CO	4292.300	62.000	21.947
CDA	CONTROL DATA CORP	4292.000	81.900	0.500
BNI	BURLINGTON NORTHERN	4197.597	77.095	8.556
WY	WEYERHAEUSER CO	4186.222	30.979	26.480
INI	INTERNORTH INC	4158.984	17.561	1.952
BN	BORDEN INC	4111.273	16.582	0.044
AC	AMERICAN CAN CO	4063.401	24.900	3.700
MCK	MCKESSON CORP	4053.712	15.398	0.816
CBS	CBS INC	4052.270	13.800	0.101
AMB	AMERICAN BRANDS INC	4025.810	356.936	20.477
IP	INTL PAPER CO	4015.201	122.400	26.400
CHR	CHARTER CO	3970.301	21.625	8.856
~~TXC~~	~~TEXACO CANADA INC~~	~~3876.000~~	~~207.000~~	~~12.000~~X
E	TRANSCO ENERGY CO	3869.328	28.968	7.750
HNZ	HEINZ (H.J.) CO	3738.445	51.636	0.805
CHA	CHAMPION INTERNATION	3737.377	17.996	15.189
MA	MAY DEPARTMENT STORE	3670.369	42.505	0.313
E1	TRANSCONTINENTAL GAS	3652.614	23.214	15.815
BMY	BRISTOL-MYERS CO	3599.901	180.900	1.300
QBDW	BALDWIN UNITED CORP	3598.010	88.982	1.388
OI	OWENS-ILLINOIS INC	3552.901	11.700	1.700
NCR	NCR CORP	3526.216	149.654	0.015
FMC	FMC CORP	3498.792	37.778	3.500
TOS	TOSCO CORP	3465.963	33.505	0.097
WMT	WAL-MART STORES	3376.251	44.202	0.637
ESM	ESMARK INC	3303.219	35.195	3.952
MES	MELVILLE CORP	3261.648	43.680	0.157
ALS	ALLIED STORES	3215.634	21.449	0.097
BOR	BORG-WARNER CORP	3195.301	8.400	0.200
DG	ASSOCIATED DRY GOODS	3188.857	52.294	13.365
PC	PENN CENTRAL CORP	3165.401	35.100	35.000
CZ	CELANESE CORP	3062.001	109.000	4.000
CHH	CARTER HAWLEY HALE S	3054.763	4.821	1.672
RLM	REYNOLDS METALS CO	2980.901	68.900	2.600
MZ	MACY (R.H.) & CO	2979.390	14.858	0.652
ZB	CROWN ZELLERBACH	2957.501	44.300	18.400
TXT	TEXTRON INC	2936.001	51.300	5.100
BCC	BOISE CASCADE CORP	2912.449	0.506	0.247
KLU	KAISER ALUMINUM & CH	2911.501	102.800	0.700
G1	ARMOUR & CO	2890.184	13.445	2.085
TXG	TEXAS GAS RESOURCES	2877.589	67.068	2.195
~~COU~~	~~COURTAULDS PLC-ADR~~	~~2875.856~~	29.363	0.148X
IAD	INLAND STEEL CO	2807.602	33.053	0.779
IR	INGERSOLL-RAND CO	2774.725	6.254	5.720
~~HWR~~	~~WALKER (HIRAM) RESOU~~	~~2697.821~~	120.170	35.006X
MEA	MEAD CORP	2666.501	1.900	0.800
KDE	KIDDE INC	2655.334	15.333	4.344

Oct 19, 1983 10:32 Page 3

TAXES PAYABLE GREATER THAN PREFERRED DIVIDENDS

Ticker	Company Name	SALES	INCOME TAX PAYABLE	PREFERRED DIVIDENDS
OAT	QUAKER OATS CO	2611.301	18.400	4.100
2868B	RAPID-AMERICAN CORP-	2570.678	42.231	0.108
ISS	INTERCO INC	2566.605	18.010	7.478
~~BWTRY~~	~~BOWATER PLC-ADR~~	~~2533.787~~	~~35.434~~	~~0.485~~ ✓
SMF	SINGER CO	2522.701	11.600	5.300
~~DLP~~	~~DUNLOP HOLDINGS PLC~~	~~2468.001~~	~~44.000~~	~~1.000~~ X
AV	AVCO CORP	2459.291	128.847	5.377
ETN	EATON CORP	2452.573	80.583	0.772
TSO	TESORO PETROLEUM COR	2439.853	7.467	5.602
UT	UNITED TELECOMMUNICA	2428.717	101.283	4.897
AMX	AMAX INC	2415.499	131.600	24.100
~~DMP~~	~~DOME PETROLEUM LTD~~	~~2381.001~~	~~218.500~~	~~11.200~~ X
REV	REVLON INC	2350.987	69.405	26.742
CAG	CONAGRA INC	2319.973	6.007	1.949
NWT	NORTHWEST INDUSTRIES	2306.600	22.300	3.500
SPP	SCOTT PAPER CO	2293.435	18.842	5.740
PZL	PENNZOIL CO	2268.510	32.473	3.980
NL	NL INDUSTRIES	2213.520	69.735	4.313
AMA	AMFAC INC	2211.701	1.789	0.772
TPN	TOTAL PETROLEUM OF N	2195.429	28.037	6.468
ZY	ZAYRE CORP	2139.616	4.413	0.057
AST	AMERICAN STANDARD IN	2124.518	23.320	0.097
2822A	CHESAPEAKE & OHIO RA	2095.961	62.586	8.628
IU	IU INTERNATIONAL COR	2070.093	34.235	1.426
GY	GENERAL TIRE & RUBBE	2061.657	26.154	0.258
R	UNIROYAL INC	1967.221	25.087	4.889
JWC	WALTER (JIM) CORP	1925.160	25.157	1.411
SHW	SHERWIN-WILLIAMS CO	1851.776	13.079	0.801
SGP	SCHERING-PLOUGH	1817.899	77.000	3.300
CTC	CONTINENTAL TELECOM	1817.688	28.554	6.231
GTE12	GENERAL TELEPHONE CO	1805.517	128.897	15.074
MAN	MANVILLE CORP	1772.229	31.544	24.990
NME	NATIONAL MEDICAL ENT	1747.000	28.000	0.498
EMH	EMHART CORP	1710.400	21.800	0.300
1602A	MARMON GROUP INC	1697.438	30.982	8.814
WKR	WHITTAKER CORP	1673.604	60.666	0.644
BAX	BAXTER TRAVENOL LABO	1671.445	27.323	0.046
GLD	GOULD INC	1643.100	24.800	0.300
RII	RAYMOND INTL INC-DEL	1638.336	16.550	0.213
EY	ETHYL CORP	1614.626	30.374	5.621
NWP	NORTHWEST ENERGY	1601.832	13.298	6.374
STA	STALEY (A.E.) MFG CO	1588.114	3.017	2.266
CUM	CUMMINS ENGINE	1587.476	10.369	5.940
DIA1	NATOMAS CO	1587.048	14.207	10.000
BES	BEST PRODUCTS	1581.650	21.993	0.022
CKE	CASTLE & COOKE INC	1551.725	5.791	4.832
NAC	NATIONAL CAN CORP	1541.543	17.257	2.028
TEX	TEXAS AIR CORP	1516.320	7.307	0.052
HUM	HUMANA INC	1516.311	39.452	6.910
NWT1	PHILADELPHIA & READI	1510.892	31.213	0.850
DR	NATIONAL DISTILLERS	1499.000	18.700	9.300

Oct 19, 1983 10:32

TAXES PAYABLE GREATER THAN PREFERRED DIVIDENDS

Ticker	Company Name	SALES	INCOME TAX PAYABLE	PREFERRED DIVIDENDS
LSI	LEAR SIEGLER INC	1464.190	17.041	0.786
IGL	INTL MINERALS & CHEM	1462.000	61.300	0.400
PBI	PITNEY-BOWES INC	1455.280	37.400	5.949
W	WESTVACO CORP	1449.664	12.718	0.008
~~DTC~~	~~DOMTAR INC~~	~~1371.206~~	~~4.553~~	~~0.407~~ X
17378	GRAYBAR ELECTRIC CO	1358.430	2.082	0.029
Y	ALLEGHANY CORP	1349.742	14.398	8.957
MAT	MATTEL INC	1341.914	25.198	6.037
USG	U S GYPSUM CO	1324.838	20.568	0.757
PC2	PENNSYLVANIA CO	1305.400	1.600	0.400
ACK	ARMSTRONG WORLD INDS	1285.590	1.890	0.443
USR	U S SHOE CORP	1254.138	23.125	1.470
JCI	JOHNSON CONTROLS INC	1251.522	11.148	1.510
2035A	AVCO FINANCIAL SERVI	1232.846	95.832	0.008
MHP	MCGRAW-HILL INC	1193.587	63.396	0.032
ASR	AMSTAR CORP	1191.135	3.565	1.127
CGP1	COLORADO INTERSTATE	1165.842	33.780	2.655
AVT	AVNET INC	1164.698	18.225	0.081
CNT	CENTEL CORP	1156.180	29.330	1.244
TET2	TRANSWESTERN PIPELIN	1153.173	12.179	1.216
DRV	DRAVO CORP	1151.617	2.464	0.387
SFS	SUPER FOOD SERVICES	1128.511	1.581	0.130
CR	CRANE CO	1126.398	1.933	0.006
IMC	INTL MULTIFOODS CORP	1118.242	6.710	0.239
PWJ	PAINE WEBBER INC	1099.814	41.657	1.851
LOF	LIBBEY-OWENS-FORD CO	1098.597	11.450	4.813
FEN	FAIRCHILD INDUSTRIES	1093.261	18.390	12.693
SNG	SOUTHERN NEW ENG TEL	1081.200	11.600	5.800
BC	BRUNSWICK CORP	1068.243	0.909	0.092
AMF	AMF INC	1054.218	44.381	0.052
CFSC	CFS CONTINENTAL INC	1043.462	2.898	0.311
23058	BALTIMORE & OHIO RAI	1016.661	27.637	2.399
[illegible]	~~COMINCO LTD~~	~~1003.033~~	~~13.175~~	~~8.504~~ X
UST	U S INDUSTRIES	971.367	13.697	3.295
SNS	SUNDSTRAND CORP	961.573	24.225	0.015
PD	PHELPS DODGE CORP	957.795	39.865	3.775
PSM	PENNWALT CORP	952.400	7.782	3.569
ZAL	ZALE CORP	939.756	2.038	0.126
REX	REXNORD INC	936.552	21.668	0.110
NYT.A	NEW YORK TIMES CO-CL	925.292	2.205	0.157
DIG	DI GIORGIO CORP	920.578	3.698	0.951
ERS	EDISON BROTHERS STOR	915.900	13.441	0.059
ARH	ANCHOR HOCKING CORP	903.574	0.758	0.012
GTE2	GENERAL TELEPHONE CO	886.122	36.726	7.171
~~CLU~~	~~CLUETT, PEABODY & CO~~	~~875.620~~	~~5.956~~	1.395 X
NIKE	NIKE INC-CL B	867.212	11.102	0.030
HMX	HARTMARX CORP	863.231	3.212	0.062
SYN	SYNTEX CORP	813.281	41.857	1.126
MLR	MIDLAND-ROSS CORP	790.897	2.144	0.078
GTE15	GENERAL TELEPHONE CO	771.020	31.842	7.638
FIN	FINANCIAL CORP OF AM	764.367	25.038	0.237

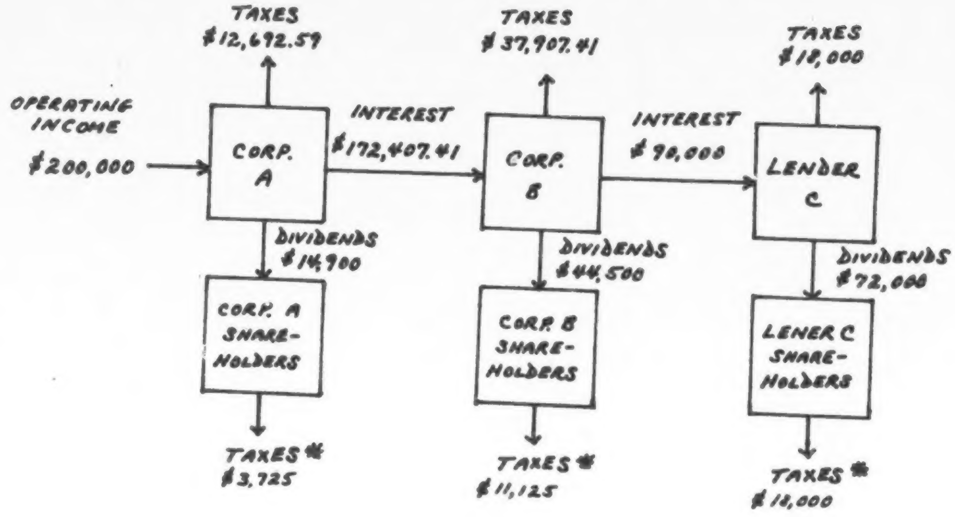
TAXES PAYABLE GREATER THAN PREFERRED DIVIDENDS

Ticker	Company Name	SALES	INCOME TAX PAYABLE	PREFERRED DIVIDENDS
CMZ	CINCINNATI MILACRON	759.688	6.631	0.240
WHX	WHEELING-PITTSBURGH	755.083	6.114	4.976
MGC	MAGIC CHEF INC	754.399	9.771	3.731
FMO	FEDERAL-MOGUL CORP	735.344	5.450	0.439
KSC	KAISER STEEL CORP	734.935	42.043	0.588
MCCRK	MCCORMICK & CO	717.678	11.001	0.015
BFI	BROWNING-FERRIS INDS	714.945	20.081	1.028
NEM	NEWMONT MINING CORP	711.605	25.225	0.777
DDS.A	DILLARD DEPT STORES-	711.323	3.040	0.022
FIGI	FIGGIE INTL HOLDINGS	708.331	10.662	1.425
DAY	DAYCO CORP	704.509	1.591	0.141
SCO	SCOVILL INC	691.399	1.477	0.166
BMS	BEMIS CO	681.363	6.641	0.115
WSN	WESTERN CO OF NORTH	676.530	22.239	1.270
FHP1	MARYLAND CUP CORP	655.875	3.516	0.025
SYB	SYBRON CORP	639.594	16.059	1.921
INR	INSILCO CORP	636.034	0.823	0.117
~~CKO~~	~~CARLING O'KEEFE LTD~~	~~635.224~~	~~16.499~~	1.650 A
BNK	BANGOR PUNTA CORP	622.320	8.872	0.695
~~ROM~~	~~RIO ALGOM LTD~~	~~618.010~~	~~8.048~~	3.090 X
NCS	NATIONAL CONVENIENCE	617.438	0.948	0.036
PKD	PARKER DRILLING CO	615.861	10.176	0.118
BHW	BELL & HOWELL CO	611.805	6.102	0.017
FQA	FUQUA INDUSTRIES INC	607.480	12.979	0.417
BFD.B	BROWN-FORMAN DISTILL	604.852	19.608	0.471
CNT1	CENTRAL TELEPHONE CO	604.430	17.208	1.267
DSN	DENNISON MFG CO	577.281	4.936	0.648
ARM	ARMSTRONG RUBBER	575.877	3.034	0.212
GA	GULFSTREAM AEROSPACE	575.477	26.716	0.440
MOH	MOHASCO CORP	559.614	1.392	0.074
OAK	OAK INDUSTRIES INC	545.720	3.930	0.023
ZOS	ZAPATA CORP	537.094	22.203	0.546
EPI	EAGLE-PICHER INDS	531.452	3.701	0.076
SVC	STOKELY-VAN CAMP INC	525.214	5.216	0.764
FHR	FISHER FOODS INC	524.328	1.506	0.107
RDK	RUDDICK CORP	521.759	3.126	0.385
RB	READING & BATES CORP	516.824	8.219	6.045
COX	COX COMMUNICATIONS I	514.746	3.387	0.060
ARV	ARVIN INDUSTRIES INC	513.905	2.954	1.138
BOL	BAUSCH & LOMB INC	509.736	2.352	0.059
GTE7	GENERAL TELEPHONE CO	505.467	13.910	4.520
ICG	INTER-CITY GAS CORP	504.639	2.398	0.724
CLE	COLE NATIONAL CORP	500.319	8.578	0.016
247	*** TOTALS ***	*****.***	18340.009	1656.919

229 [illegible] 1527.627 /

ALTERNATIVE # 2 - 17.24% SUB. NOTES LEVERAGED WITH 12% DEBT

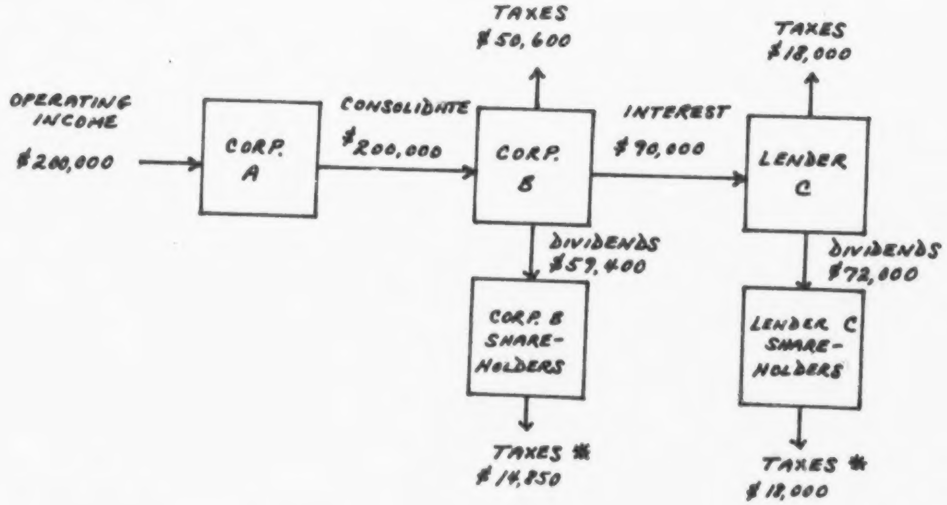
TOTAL TAXES = $101,450 / DEFERRABLE PORTION = $32,850


OPERATING INCOME
$200,000
TAXES
$12,692.59
CORP. A
INTEREST
$172,407.41
DIVIDENDS
$14,900
CORP. A SHARE-HOLDERS
TAXES *
$3,725
TAXES
$37,907.41
CORP. B
INTEREST
$90,000
DIVIDENDS
$44,500
CORP. B SHARE-HOLDERS
TAXES *
$11,125
TAXES
$18,000
LENDER C
DIVIDENDS
$72,000
LENER C SHARE-HOLDERS
TAXES *
$18,000

(*) TAX DEFERRED TO EXTENT DIVIDENDS ARE LESS THAN 100% OF NET INCOME

ALTERNATIVE #3 - CONTROL COMMON STOCK LEVERAGED WITH 12% DEBT

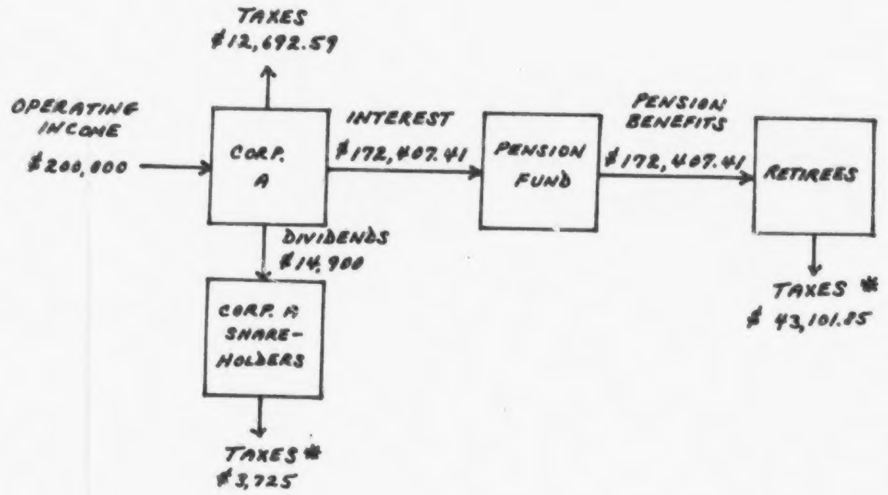
TOTAL TAXES = $101,450 / DEFERRABLE PORTION = $32,850


OPERATING INCOME
$200,000
CORP. A
CONSOLIDATE
$200,000
TAXES
$50,600
CORP. B
INTEREST
$90,000
TAXES
$18,000
LENDER C
DIVIDENDS
$59,400
CORP. B SHARE-HOLDERS
TAXES *
$14,850
DIVIDENDS
$72,000
LENDER C SHARE-HOLDERS
TAXES *
$18,000

(*) TAX DEFERRED TO EXTENT DIVIDENDS ARE LESS THAN 100% OF NET INCOME

ALTERNATIVE #4 - 17.24% SUB. NOTES SOLD TO TAX-EXEMPT PENSION FUND

TOTAL TAXES = $59,519.44 / DEFERRABLE PORTION = $46,826.85


TAXES
$12,692.59
OPERATING INCOME
$200,000
CORP. A
INTEREST
$172,407.41
PENSION FUND
PENSION BENEFITS
$172,407.41
RETIREES
DIVIDENDS
$14,900
CORP. A SHARE-HOLDERS
TAXES *
$3,725
TAXES *
$43,101.85

(*) TAX DEFERRED TO EXTENT DIVIDENDS/PENSION BENEFITS ARE LESS THAN 100% OF NET INCOME AND INTEREST RESPECTIVELY

Statement by Deloitte Haskins & Sells
on
Senate Finance Committee Proposals
for
The Reform and Simplification of the Income Taxation of Corporations

November 7, 1983

Deloitte Haskins & Sells is a public accounting firm that provides tax advice to a diverse group of clients with respect to tax planning and tax compliance. The comments submitted are general observations of the firm and do not necessarily reflect the particular views of our clients.

Because of the complexity and scope of the staff's proposals to modify subchapter C of the Internal Revenue Code, their report will require extensive study in order to understand and appraise its impact on a variety of transactions that will be affected by the changes. We look forward to offering further comments and assistance to the Committee and its staff as its work on these proposals continue.

The staff report describes many complexities and inconsistencies in the taxation of corporations and proposes significant changes. The report states four goals of the study: (1) To simplify the taxation of corporate transactions; (2) to prevent corporations from obtaining unintended tax benefits; (3) to make the tax law more neutral with respect to the structuring of corporate transactions; and (4) to improve compliance with the tax laws. In support of these goals three principal proposals are presented: (1) a new system for taxing corporations and shareholders participating in corporate acquisitions and liquidations would be enacted; (2) the taxation of distributions to shareholders would be changed by repealing the _General Utilities_ doctrine*] and eliminating the earnings and profits limitation on the characterization of corporate distributions as dividends; and (3) a new set of rules would be created to determine the extent to which net operating losses and other corporate tax attributes survive corporate acquisitions. The report also proposes that publicly traded partnerships be classified as corporations and addresses certain issues arising in connection with the taxation of foreign corporations.

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*] _General Utilities & Operating Co. v. Helvering_, 296 U.S. 200 (1935).

We fully share the goals of simplifying the taxation of corporations. However, the staff proposal does not in any manner simplify but in effect under this guise, raises significant tax revenue by devising a scheme for taxing corporate income at both the corporate and shareholder level. In so doing the statute makes paramount, rather than neutral, a decision as to whether the corporate form of doing business is chosen. Any reforms that increase this double tax and give such onerous results, even in the name of simplicity, will not accomplish the goal to make things simple.

Mergers and Liquidation Proposals

The staff report outlines a series of changes to the tax treatment of corporate transactions, including mergers, other acquisitions, incorporations and liquidations. The definitional rules for acquisitive reorganizations would be substantially changed. Second, corporate transferees would be entitled to a cost basis only if the corporate transferor recognized gain. Third, the tax consequences at the shareholder level would be determined independently of the tax consequences at the corporate level. Fourth, the collapsible corporation rules of section 341 of the Code would be repealed.

In general, the staff proposals to simplify the definitional rules of corporate reorganizations make sense. The present definitions arose over a 50 year period and do not appear to have rational differences in their requirements. For instance, a stock acquisition effectuated by a reverse merger (section 368(a)(2)(E) of the Code) allows for up to 20 percent non-voting stock consideration while the same acquisition if accomplished by a tender offer (section 368(a)(1)(B)) must be made solely in exchange for voting stock in order to qualify for reorganization treatment. Similarly, the incorporation rules of section 351 do not mesh well with the reorganization rules, often causing anomalous results. A more integrated set of rules for all reorganizations and incorporations would do much to simplify subchapter C of the Code.

However, rules separating the tax treatment of shareholders from those of their corporations should be enacted only after careful study. Elections are not necessarily simpler than the provisions they replace. Section 338 of the Code, enacted just last year, was supposed to simplify the provision enabling corporate taxpayers to treat stock acquisitions as asset acquisitions, but the statute will require at least nine major regulation provisions, none of which has yet been published by Treasury. Despite two technical corrections bills, section 338 is still not workable in day-to-day transactions.

Present law governing corporate reorganizations, as developed over the prior 50 years, is based on a distinction between what constitutes a sale and exchange and what constitutes a continuation of a corporate business in a modified corporate form. As such, despite their complexities, the provisions have provided flexibility. The concept of continuity of business enterprise and continuity of shareholder interest are essential elements of that distinction. The problems with the administration of those concepts has been in the lack of statutory definition rather than with the principles themselves.

Similarly, the problems that taxpayers and the courts have wrestled with concerning liquidation/reincorporation problems have stemmed from a lack of statutory definition of that concept. A simplification of the reorganization rules would go a long way towards removing the uncertainties in this area.

Repeal of General Utilities

The repeal of the General Utilities doctrine, and the resulting double taxation on corporate distributions is an essential element in the staff's proposal. The staff justifies this additional tax because it would be less complex than our present system, allowing for an election by an acquiring corporation to determine whether to take a carryover or cost basis in assets and allowing for the repeal of the complex collapsible corporation provisions.

The staff's recommendation to repeal the General Utilities doctrine is based, in part, on the assumption that we have an unintegrated corporate tax system and that such a system is likely to continue for the foreseeable future. However, at present General Utilities mitigates this harsh result with respect to appreciation of corporate assets. In addition, the ability to retain earnings coupled with a capital gain tax by the shareholders on the ultimate disposition of the business has integrated the corporate and shareholder tax to a large degree. Although, as the staff report points out, we are unlikely to achieve a fully integrated tax system in the near term, the proposed repeal of the General Utilities doctrine would be a step in the wrong direction, away from integration.

When a corporation is liquidated, the recapture provisions insure that previously untaxed corporate income is taxed. The retained income has already been taxed at the corporate level at ordinary rates. What has not yet been taxed is the underlying appreciation of the corporate assets, which is, to a large measure, reflected in the appreciation in the value of the outstanding stock. It makes economic sense to tax this appreciation only once.

As presently limited by the Code, the General Utilities doctrine is applied with a bias towards closely held business. While it is true that closely held businesses may be less able to afford the tax consequences of double taxation, there is little equitable or economic justification in restricting the doctrine from applying to distributions from widely held corporations as well.

Limitation on Dividends Received Deduction

The Senate Finance Committee staff identifies two areas of concern with respect to the 85 percent dividend received deduction. Their first concern is that the allowance of an 85 percent dividend received deduction coupled with a short term capital loss on a subsequent sale of the stock produces an unintended tax benefit. The second concern involves the use of a leveraged purchase of dividend producing stock to obtain an offsetting interest deduction coupled with the 85 percent dividend received deduction. In response to these concerns, the staff proposes to increase the minimum holding period of stock on which dividends paid would be eligible for the dividends received deduction to one year.

We do not feel that an across-the-board extension of the holding period in order to qualify for the dividends received deduction is appropriate to the perceived tax abuse. In addition, we feel that such an extension would place an undue penalty on corporations with significant trading activities, such as personal holding companies.

The dividend received deduction is essential to a federal tax system that involves taxation of corporate income both at the corporate and at the shareholder level. The theory of a dividend received deduction is that corporate income should be taxed only once until distributed to individuals or other non-corporate shareholders. In fact, since the repeal of the multiple surtax exemption for affiliated corporations in 1969, there is little justification for a less than 100 percent dividend received deduction.

We agree that no economic loss has been sustained by a corporation to the extent that the loss reported stems from a decline in value of the underlying stock resulting from the payment of the dividend eligible for the 85 percent dividend received deduction. We do not feel that an extension of the minimum holding period necessary to qualify for the dividends received deduction is the proper remedy. It seems to us that the unintended benefit is not the dividends received deduction but rather the short term capital loss that results from payment of the dividend. Therefore, we feel that the lengthening of the holding period to qualify for the dividend received deduction is appropriate only where the corporate investment risk bears an inappropriate relationship to the magnitude of the dividend. A disallowance of the loss in cases where the loss is significant and can be clearly traced to payment of the dividend would be a more appropriate remedy.

Earnings and Profits Limitations

The staff report questions whether the earnings and profit limitation on dividend treatment of corporate distributions provides opportunities for abuse and, if so, whether the earnings and profits limitation should be repealed or whether a narrow set of revisions should be attempted in lieu of repeal.

Under the present rules, abuses do exist, primarily from the uncertainty that exist in the manner in which earnings and profits are to be computed. We feel, however, that the outright repeal of the concept is not the appropriate response to such problems. The purpose of earnings and profits, to distinguish between distributions of earnings and capital, is appropriate to mitigate the impact of our dual system of taxation. The concept of earnings and profits is key to the application of a number of other provisions of the Code. These applications would continue under the Staff proposals, with the result that the need to compute earnings and profits would remain for both large and small corporations.

Limitations on Net Operating Losses and Other Tax Attributes

We concur that the goal of rules governing the carryover of tax attributes should be neutral. Limitations should be imposed only where the economic value of the attributes are abnormally inflated. The Staff proposals intend to limit the post-acquisition utilization of attributes by reference to what the loss company's utilization of those losses would have been had no acquisition occurred.

This appears to be a generally sound approach. However, it is very important, whatever rules are adopted, that the limitations be readily calculable and that they not be arbitrary. We are concerned that any approach that involves the publication, by regulation or otherwise, of computation schedules will result in unrealistic limitations in many industries.

The Staff proposals, unlike the proposals set forth by the House, would put a limitation on the utilization of losses by the loss corporation on its acquisitions of profitable companies. We feel this would place an undue restriction on the ability of loss corporations to rehabilitate themselves. More responsive limitations could be adopted to insure that, despite the form of the acquisition, the loss corporation was the actual acquiring corporation.

Summary

The rules of corporate taxation are complex. Nevertheless we have learned to live with these rules. Complex rules that are perceived to be equitable are more acceptable than "stated" simple ones that may have arbitrary results. We suggest, therefore, that instead of abolishing 50 years of history, reforms be made with the within the current framework of Subchapter C (mainly the continuity of interest doctrine) rather than creating significant uncertainty.

Moreover, in our view, as long as we have a dual taxation of corporate income, we will need rules to mitigate the harshness of that system. To do otherwise, will discourage the formation of corporate capital, an essential element of our economy. Much of the staff proposal, primarily those involving the repeal of the *General Utilities* doctrine, would have the opposite effect. A truly neutral system of taxation, one that would neither encourage or discourage the corporate form of doing business, would not impose a double tax on the appreciation of assets while in corporate hands. Any revisions to subchapter C of the Code should be undertaken in a deliberate manner, correcting abuses by direct address rather than evoking a new system of taxation with its resulting disruptions and uncertainties upon corporate transactions.

Dorchester Hugoton, Ltd.
Dorchester Place • 5735 Pineland Dr. • Suite 129
Dallas, Texas 75231
(214) 739-2002

November 2, 1983

Committee on Finance
United State Senate
Room SD-219
Dirksen Senate Office Building
Washington, DC 20510

RE: Written Statement For the Record
On Hearing Scheduled For October 24,
1983 on The Reform And Simplification
of the Income Taxation of Corporations

Gentlemen:

This statement presents the views of Dorchester Hugoton, Ltd. with respect to the specific question as to whether "limited partnerships with publicly traded interests [should] be taxed as corporations" which was addressed at the above hearing.

We believe that publicly traded limited partnerships should continue to be taxed as partnerships rather than as corporations. We do not believe that the marketability of an entity's interests should be a sole discriminating factor in determining the manner in which the entity is taxed as the Staff of the Committee has proposed. There are long-standing and time-tested legislative and judicial criteria for distinguishing between partnerships and corporations for income tax purposes. We believe that these criteria are still appropriate in today's business environment. The United States Treasury Department also opposes the Staff's proposal.

The Staff sets forth a conclusion that "publicly traded limited partnerships are simply too similar to business entities that are taxed as corporations" to support their proposal. A footnote to the Staff's conclusion refers to an article published in Forbes in August 1983. Although the author of the article journalistically compares publicly traded limited partnerships to corporations, the article obviously does not provide a factual, detailed analysis of each of the two different types of entities. Again, there is authoritative legal precedent to guide in distinguishing between partnerships and corporations.

The Staff related in their proposals that "substantial questions have also been raised whether the partnerships tax rules work effectively for publicly traded limited partnerships". This observation apparently comes from positions taken in the American Law Institute ("ALI") Federal Income Tax Project Tentative Draft No. 7 dated March 20, 1981. This Tentative Draft states that "it may prove extremely difficult to audit a publicly traded entity if it is taxed on a pass-through basis." Based on our experiences, the mechanics of making detailed partnership calculations in today's highly technical and computerized environment are relatively simple. The American Bar Association rejected the ALI position with respect to this matter. Furthermore, the Treasury Department also believes that many of the perceived problems in this area have been subsequently eliminated or substantially reduced as a result of the partnership level audit provisions contained in the Tax Equity and Fiscal Responsibility Act of 1982.

In Dorchester Hugoton, Ltd's case, this proposal would have a profound effect on all of its limited partners. The "partnership entity" concept was selected over a year ago in compliance with and in consideration of all of the detailed aspects of the income tax code and regulations in effect at that time. A change now in the taxation structure would unjustly result in severe financial consequences to such limited partners not only in the form of unanticipated taxation but also in the value of their partnership interest. People who became limited partners subsequent to the formation of the partnership would likewise be adversely affected.

In conclusion, we believe that there is no substantive basis in the Staff's proposal that limited partnerships with publicly traded interests should be taxed as corporations and urge the Committee to remove the proposal with respect to this matter from consideration in this hearing.

Respectfully submitted,
DORCHESTER HUGOTON, LTD.
Howard C. Wadsworth
Howard C. Wadsworth
General Manager

/wpc

Comments of E.F. Hutton & Company Inc. on portions of the Senate Finance Committee's Preliminary Staff Report and Recommendations on the Reform and Simplification of Corporate and Shareholder Income Taxation

by

.Martin L. Lyons
Senior Vice President
Corporate Finance Department
E.F. Hutton & Company Inc.
One Battery Park Plaza
New York, NY 10004
(212) 742-6837

October 18, 1983

DRAFT

STATEMENT OF E.F. HUTTON & COMPANY INC.

My name is Martin L. Lyons, and I am Senior Vice President and Manager of the Public Utilities Group in the Corporate Finance Department of E.F. Hutton & Company Inc.

I am here today to comment on several issues in the Senate Finance Committee's Report and Recommendations on the Reform and Simplification of Corporate and Shareholder Income Taxation. The first issue pertains to eliminating the procedure which allows companies to pay dividends with a return of capital feature. The electric utility industry, in particular, utilizes this feature to a considerable extent. It is used almost entirely by the weakest utilities from a credit rating point of view and coincidently those engaged in the largest construction programs. Because the return of capital feature exists, these companies are able to raise capital on much more reasonable terms than they would be able to do if it were eliminated.

The second issue which I wish to address is the potential elimination of the 85% dividends received deduction for corporations. We feel that the effects of this porposal would be extremely harsh as it could seriously injure the common stock market, the preferred stock market, which relies on corporate investors to a significant extent, and the recently created adjustable rate preferred stock market which also depends on corporate investors for its existance. We recommend that this Committee not take any action that would jeopardize either the return of capital dividend treatment or the 85% dividends received deduction for corporate investors.

Thank you for considering our opinions.

E.F. Hutton & Company Inc. would like to express its opinions about the likely impact on the market for public utility company stocks, bank stocks, and on itself should several of the recommendations contained in the preliminary report released by the staff of the Senate Finance Committee on September 22, 1983 involving Subchapter C of the Internal Revenue Code (Report No. 187, G-5, J-1) become law. In particular we want to comment on:

1. The likely negative impact from eliminating "return of capital" tax treatment on the payment of common stock and preferred stock dividends.
2. The importance of the 85% dividerds-received deduction.
3. The extension of the 16-day holding period to one year and one day in order to qualify for the 85% dividends-received deduction.
4. The prohibition of deducting interest expense incurred to finance the ownership of preferred and common stock.
5. The prohibition of leveraged preferred stock financing.

E.F. Hutton & Company Inc. is one of the largest securities firms in the United States whether ranked by the number of account executives, sales offices or capital. E.F. Hutton is also one of the largest investment banking firms and acts as managing underwriter for numerous industrial corporations, public utility companies and municipal clients. For the first nine months of 1983, our Firm managed or co-managed 88 public offerings of securities with a value of $6,680,000,000. In so doing, we ranked among the top ten firms in the investment banking industry.

It is with a view toward our role as an investment banker and market maker that this statement is submitted. We believe the above recommendations, if enacted into law, would have a significant adverse impact on the ability of corporations, especially regulated public utilities and banks, to raise needed equity capital as well as adversely impact the broker/dealer community's ability to make efficient markets.

The following tables summarize the total amount of preferred stock and common stock raised by combination electric and gas utilities, telephone companies, banks and all other issuers since 1980.

Preferred Stock New Issues

Issuers:	1980		1981		1982		1983*	
	(Millions of Dollars)							
Gas & Electric Cos.	$1,634	53%	$965	60%	$1,676	34%	$1,376	19%
Telephone Cos.	0	0	0	0	30	1	0	0
Banks	210	7	0	0	1,620	32	2,490	34
All Other	1,240	40	637	40	1,630	33	3,421	47
Total	$3,084	100%	$1,602	100%	$4,956	100%	$7,287	100%

Common Stock New Issues

Issuers:	1980		1981		1982		1983	
	(Millions of Dollars)							
Gas & Electric Cos.	$3,804	31%	$4,072	31%	$4,882	35%	$2,273	7%
Telephone Cos.	9		1,155	9	1,820	13	1,388	4
Banks	232	2	198	1	161	1	2,629	8
All Other	8,207	67	7,793	59	7,016	51	25,943	81
Total	$12,252	100%	$13,198	100%	$13,879	100%	$32,233	100%

*Through September 30,1983

Source: Abrahamsen & Company, New Issues Statistics

As the above figures show, utilities and banks are the major issuers of preferred stocks, and until the new issues market rally began in early 1983, utilities played a major role in the common stock new issue market. Owing to the tremendous capital needs of the electric utility industry in particular, as well as the critical need for the nation's banks to be adequately capitalized, we believe the tax laws of the United States should encourage investors to provide the equity capital needed to enable industry to grow.

The electric utility industry contemplates that it will continue to make capital expenditures at a high level in the 1980's. Annual capital expenditures in recent years have been approximately $30 to $35 billion. This industry has externally financed approximately 60% to 65% of these expenditures. Although internally generated funds are expected to increase as a percent of capital expenditures, we expect external financing to remain high. Therefore, it is extremely important that the tax laws not be changed in the manner outlined above because each of the proposed changes will directly or indirectly increase the cost of financing for the utility industry.

With these thoughts in mind, we first want to address the impact on the securities markets if the return of capital treatment for dividend income is eliminated. Because this treatment significantly impacts electric utility companies which are engaged in large construction programs, it is important to look individually at the companies in the electric utility industry which can benefit from this provision. Attached in Exhibit A is a list of companies which we expect will offer a return of capital on their common stock and possibly preferred stock dividends in 1983 and 1984. In addition, we expect that many of these companies will need to issue equity securities in 1984 in order to continue financing their construction programs.

In view of the limited revenue effect, estimated by the Staff as less than $50 million annually, we believe the proposal should not be implemented if for no other reason than the threat to raising capital externally. Our marketing people advise us that the return of capital feature is an extremely important advantage to offer investors when new shares are being sold. But, more importantly, the return of capital feature is also a sign of financial weakness and investors realize in exchange for a tax deferred dividend, they are purchasing shares in a company which maybe weaker than the average electric utility. As a result, our marketing people say that the yields on utility securities of the lower quality companies would have to be significantly higher in order to attract sufficient interest to permit successful offerings if the return of capital feature is not available. For instance, in August of this year, our firm was a co-manager of the 4,000,000 share offering of $25 par value preferred stock made by Long Island Lighting Company (total value $100,000,000). We sold approximately 1,000,000 shares to our retail or individual customers, at a yield of 14.00%. We estimate that if the return of capital feature had not been available, the maximum number of shares that we might have sold would have been reduced by approximately 50% and the yield might have been increased to 14.50% to 14.75% owing to a general lack of interest on the part of individual and institutional investors for preferred stocks of companies which are involved in major construction programs. Thus, the return of capital feature provided an essential ingredient in making this offering a successful one. In addition, it also helped to minimize the dividend cost to the Company. This cost is directly recoverable from the Company's ratepayers and, as a result individuals, businesses and other organizations on Long Island will not be charged as much money as they would had the return of capital feature not been available.

The companies in Exhibit A represent only 21% of the largest 100 electric utilities in the U.S. Since only a small portion of these companies can be expected to have a significant amount of tax deferred income in their dividends in 1984, we conclude that the amount of potential taxable dividend income which could be paid by electric utility investors is relatively insignificant. While the benefits to the utilities are great in terms of helping them access the capital markets.

The next subject which I want to comment on is the importance of the 85% dividends-received tax deduction. Unlike the return of capital feature which normally affects individual investors, the 85% dividends-received deduction ("85% deduction") only applies to corporate investors. Such investors include industrial corporations, life and casualty insurance companies, credit companies, certain investment companies, and broker/dealers such as my Firm.

It is well know that a substantial portion of the securities issued by the nation's corporations are now held by institutions instead of individuals. Some institutions, such as pension funds do not benefit from the 85% deduction. However, many are motivated to acquire securities based on the potential after tax dividend income. If the 85% deduction is restricted, the expected dividend return on investment will decline up to roughly half the amount of the current dividend. Clearly, many institutions will be dissatisfied with this scenario and will find investing in common stocks and preferred stocks less attractive. As their portfolios are liquidated, companies will probably experience a reduction in the price of their stocks. For companies which need to raise equity capital, the result of less institutional interest will mean that these companies will need to sell more shares in order to raise the desired amount of capital and they will probably need to pay higher underwriting commissions in order to effectively distribute the shares. As noted above, the utility industry will continue to require substantial external equity in order to fund its construction program as well as support its credit ratings. Any action taken by the Congress to restrict the 85% deduction will make it more difficult for utility companies to raise capital at a time when many of these companies are already financially strapped.

In addition, restrictions on the 85% deduction would hurt other industries which need additional capital. Some U.S. commercial banks fall into this category and benefit from being able to issue preferred stock which is considered capital on their balance sheets. In recent years, banks have issued sizeable amounts of preferred stock. Since May, 1982, U.S. commercial banks have offered 38 issues of adjustable rate preferred stocks totalling $4,075,500,000. The principal buyers of these adjustable rate preferred stock issues are corporate treasurers who use them to invest surplus cash temporarily.

Their criteria for investing is to earn the highest possible after-tax return. If the 85% deduction is restricted, the market for these securities will be seriously injured since investors will now require substantially higher yields in order to be attracted to these shares. Due to the complexity of the dividend setting formula, it is likely that many corporations would not continue to invest in adjustable rate preferred stocks when less complicated securities are available for investment.

In addressing the cost impact of restrictions on the 85% deduction, it is our opinion that the common stock market would be depressed by restrictions on the 85% deduction. It is impossible to determine the magnitude of harm that would be done to the stock market. However, it is obvious that corporate investors will be less inclined to purchase equity securities and a certain amount of cash will be diverted into other investments.

With regard to preferred stocks, it might be easier to quantify the effects of restrictions of the 85% deduction. It is logical to assume that a preferred stock which does not offer tax sheltered income should offer a yield in the market which is greater than the subordinated debt of an issuer. Therefore, if an investment grade company (a company whose debt is rated triple-A, double-A or single-A or Baa/BBB by Moody's and Standard & Poor's, respectively) has outstanding debt rated double-A, then we could expect the preferred stock of that company to require a slightly higher yield in the marketplace, perhaps, a quarter to a half point higher. However, if a company's senior debt is rated Baa/BBB, the lowest quality in the investment grade category, then it is reasonable to expect that its unsecured or junior debt would be rated below investment grade, that is Ba/BB, and that the preferred stock would be regarded as inferior to the junior debt and would require a considerably higher yield. Assuming this is the case, the yield required to market a new issue of preferred stock could be up to two to three percentage points higher than it would be if the 85% dividend deduction is fully available.

As an alternative to outright repeal of the 85% deduction, it appears that the staff of the Finance Committee is also considering ways of reducing "abuses".

The proposal to extend the holding period for qualifying for the 85% deduction is an effort to accomplish this end. We believe that if the holding period is extended to one year that significant harm will be done to the several equity markets that currently exist. The traditional stock market will lose a certain amount of capital currently invested in it. It is impossible to know how many institutions would find common stocks unattractive and how much cash would be moved to other investments if the holding period is extended to one year before they could qualify for the 85% deduction.

Likewise, the preferred stock market would suffer because institutional investors are willing to accept a lower dividend on preferred stock because of the 85% deduction than they would accept if it did not exist. The question of how much this market will be hurt is impossible to answer, however, we are convinced that some investors would move out of the preferred market to a meaningful extent. It should be noted that utilities, particularly electric utilities, rely on preferred stock for a significant portion of their capitalization. As of approximately mid-1983 the capitalization ratios of the 100 largest electric and combination electric and gas utilities were 48.9% debt, 11.7% preferred and preference stock and 39.4% common equity. Utility managements are encouraged by state and Federal Energy Regulatory Commission regulators to maintain a reasonably high component of preferred stock in their capitalization structures. The cash required to pay the dividends on preferred stock comes directly from revenues collected directly from individual, commercial, industrial and governmental rate payers. Therefore any action on the part of this Committee and the Congress to alter the 85% deduction in a way which would cause preferred stock financing costs to rise, would be felt directly by electricity consumers across the nation.

In addition to harming the traditional preferred stock market, extention of the holding period to one year would also hurt the relatively new adjustable rate preferred stock market. Adjustable rate preferred stocks, as discussed above appeal directly to corporate cash managers who compare the after tax yield on adjustable rate preferred stocks to yields available from other taxable and tax-exempt short-term securities. As an example, some adjustable rate preferred stocks offer a yield as low as 9.50% while some fixed rate preferred stocks offer yields above 14%. Since the rates on adjustable rate preferred stocks change every three months, investors have the option to sell their stock if the rate level changes to a yield which they consider to be undesirable. Because of the frequent adjustments in the dividend rate, these stocks tend to trade near their par values and therefore investors do not expect to take significant losses if and when they choose to sell. It is the short-term time horizon of these corporate investors which makes the 16-day holding period essential. In the event that the 16-day holding period is extended to one year, outstanding adjustable rate preferred stocks would be severly hurt and few if any new issues could be launched. Therefore, we urge this Committee and the Congress not to make any significant changes in the 16-day holding period. In view of the limited revenue impact noted above, this proposal does not warrant passage.

The fourth topic which we want to address concerns the deductibility of interest on funds borrowed to invest in equity securities. If such interest deductions are disallowed, a considerable amount of money is likely to leave the equity markets. Capital formation would be adversely affected and values of securities would decline. Again, it is impossible to state what the magnitude of this change would be and what it would do to the equity markets.

However, it would probably be significant, in addition, the loss of this deduction would discourage firms such as mine from making liquid markets in over-the-counter securities as well as positioning large blocks of stock which are purchased from institutions with the expectation of selling them to other institutions. The leading securities firms make a regular practice of positioning large blocks of securities every day in the performance of their dealer functions. The loss of the interest deduction would significantly increase the cost of carrying these securities and hinder our efforts at making efficient markets. We urge that this deduction not be eliminated on the grounds that it would discourage dealers from making efficient over-the-counter and institutional markets. The staff estimate of revenue of $200 million in 1984, $400 million in 1985, and $500 million in 1986 does not justify this proposal.

Lastly, we want to address a financing practice known as leveraged preferred stock. Only a limited number of these transactions have been arranged since their inception approximately two years ago. This concept enables companies, especially utility companies, to arrange preferred stock financings at rates which are significantly below the rate for issuing traditional preferred stocks. These financings are complicated in structure, but the companies that arrange them wind up with a lower cost of money than if they had sold a standard long-term preferred stock. As a result, electric rates are kept lower than they otherwise would be and we therefore urge this Committee and the Congress not to penalize leverage preferred stock financing.

In conclusion, we believe that the capital formation process is a delicate one and to remove any of the tax incentives to making it easier and more efficient for corporations to obtain equity capital is not in the long run best interests of the Nation. Thank you for considering this statement.

Exhibit A

Return of Capital Estimates

	1983	1984
American Electric Power	0-10%	small if any
Arizona Public Service	25-35%	small if any
Carolina Power & Light	some-no est.	
Commonwealth Edison	40%	none
Consumers Power	100%	100%
Preference Stock	75%	none
Detroit Edison	50%	less
Duke Power	some	maybe some
El Paso Electric	30%	some
Kansas Gas & Electric	75-85%	about the same
Long Island Lighting	100%	100%
Preferred Stock	some	maybe
Middle South Utilities	70%	50%
New York State Electric & Gas	0-10%	probably more
Niagara Mohawk Power	25-35%	some, no est.
Ohio Edison	75%	50%
Pennsylvania Power & Light	50%	small if any
Philadelphia Electric	close to 100%	some, no est.
Public Service of New Hampshire	100%	probably 100%
Preferred Stock	75%	some
Puget Sound Power & Light	100%	none
Toledo Edison	65%	some, no est.
Union Electric	75%	no estimate
Washington Water Power	some, no est.	none

The
Employee
Stock Ownership
Association

The ESOP Association
1725 DeSales Street N.W
Suite 400
Washington, DC20036
202-293-2971

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Vice President
Corporate Relations
E-Systems, Inc.

Managing Director
Luis Granados

Testimony of Luis Granados
Concerning Reform of Subchapter C

Submitted to the Senate Finance Committee
October 24, 1983

My name is Luis Granados. I am the Managing Director of The ESOP Association, the national, nonprofit association of companies with Employee Stock Ownership Plans (ESOPs).

The ESOP Association supports the efforts of this Committee to rationalize the complex tax laws governing corporate transactions. We agree that transactions of similar economic substance should be taxed in a similar manner. My testimony recommends changing the tax treatment of a corporate transaction common to ESOPs in such a manner that it would be treated the same as other transactions leaving the parties in the same economic position.

The owner of a closely held corporation who is planning for his retirement faces the problem of turning his closely held stock into a liquid asset that he can make use of. Because there is no market for the stock, he cannot simply pick up the phone and sell it. Two of the most attractive options available to the thousands of business owners in this position are (1) to merge into another company, or (2) to sell the stock to employees through the device of an ESOP.

Should the owner choose the first alternative of a merger, he can take advantage of Subchapter C's tax-free exchange rules for reorganizations as defined in IRC Section 368. He can swap his stock for stock of the acquiring company, which may be publicly traded and therefore fully liquid. No gain is recognized on this transaction, so no tax is paid. The original basis of the closely held stock is transferred to the stock acquired in the swap transaction, so that full capital gains tax will be paid when the acquired stock is resold. However, the owner benefits from the right to defer payment of tax, and the option to pay tax at his leisure by selling off the acquired stock at his leisure.

Should the owner choose the second alternative, he would sell his stock to an ESOP trust, presumably for cash. If he invested that cash in stock of a publicly traded company, he would be in precisely the same economic position he would be in if he had engaged in a merger. However, he would be taxed differently; he would have to pay full capital gains tax right away, as opposed to the deferral he could achieve by engaging in a tax-free merger.

This differing treatment is discriminatory on its face, and if it is the intention of the Committee to treat like transactions similarly then it should be addressed.

Testimony of Luis Granados
Concerning Reform of Subchapter C
October 24, 1983

Moreover, as a matter of public policy, the direction in which this discrimination encourages business owners to move is an undesirable one. On the one hand, the "merger mania" afflicting the business community has been roundly criticized as wasteful of precious capital and managerial time and talent in unproductive activity. This activity does not produce goods and services that people want; it enriches primarily lawyers and stock speculators. Business observers such as the authors of the recent bestseller "The Search for Excellence" also note that the entities that emerge from these combinations tend not to be as efficient, productive, or profitable as they were when they were independent.

On the other hand, a number of independent studies have associated employee ownership with improved employee motivation and productivity, and thus with improved profitability. A University of Michigan study found employee owned firms to be 50% more profitable than similar sized firms in similar industries. A University of Iowa study showed that while national productivity rates were dropping by 3% in the late 1970s, the same rates were rising by 3% among ESOP companies. Congress on a number of occasions has expressed strong encouragement for the expansion of the ESOP concept. We ask that this opportunity to rectify an unintentional discrimination against ESOPs not be allowed to slip by.

The problem can be solved by legislation similar to Section 11 of last year's S.1162. Where a control block of stock, as defined in IRC Section 368, is sold to an ESOP as defined in Section 409A or in Section 4975(e)(7) and the proceeds are reinvested within a reasonable period of time in other securities, then the exchange ought to be considered a tax-free reorganization.

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STATEMENT OF THE FIRST BOSTON CORPORATION ON THE PROPOSAL OF THE SENATE FINANCE COMMITTEE STAFF IN "THE REFORM AND SIMPLIFICATION OF INCOME TAXATION OF CORPORATIONS" TO ELIMINATE THE EARNINGS AND PROFITS LIMITATION ON DIVIDENDS

in connection with

HEARING ON REPORT ON REFORM
OF CORPORATE TAXATION

October 24, 1983

Submitted to the

SENATE FINANCE COMMITTEE

November 1, 1983

I. Introduction

The First Boston Corporation is pleased to have this opportunity to discuss and comment upon the proposal contained in the Report of the Senate Finance Committee Staff to eliminate the earnings and profits limitation on dividends. We have already submitted a statement (dated October 20, 1983) dealing with the proposals to restrict the deductibility of interest under an expanded version of Section 265 of the Internal Revenue Code and to extend the holding period for the 85% dividends received deduction. Again, we commend the Committee and its Staff for undertaking an extensive review of possibilities for reform, simplification and elimination of abuses in the taxation of corporations.

Our comments will focus upon public utilities, because the public utility industry distributes nearly all of the return of capital dividends and traditionally has been among the largest private issuers of common stock in the country. We believe that the impact of the proposed change on public utilities and their ratepayers and shareholders will be extremely damaging. Many of our remarks, however, may apply to other industries paying dividends which under current law would be treated as returns of capital.

II. Summary

Limiting dividend treatment to distributions from current or accumulated corporate earnings and profits has been based upon the rationale that taxable dividends should be limited to distributions of corporate income and that other distributions properly should be viewed as a return of invested capital. This concept has been an enduring one, as the current limitation has been in the Internal Revenue Code since 1936 and a more restrictive version appeared from 1913 to 1936. We agree with the Staff Report that the earnings and profits limitation in some cases may have led to tax-free distributions not contemplated by Congress. However, the vast majority of return of capital distributions are properly entitled to be treated as a return of invested funds rather than a return on invested funds. In particular, we believe that the practices questioned by the Staff are totally absent from the public utility industry. Any questionable situations which may exist in other industries should be addressed by appropriately focussed corrective legislation designed to eliminate specific unintended results without creating unnecessary hardships for public utility issuers, investors and ratepayers.

Elimination of the return of capital rule would seriously and adversely impact the public utility industry by increasing the cost of new equity and possibly forcing companies to adopt inappropriate capital structures. It also may have other undesirable and inequitable effects, including a decline in the market value and liquidity of existing stocks on which return of capital distributions have been made, and an increase in rates charged to utility customers. Individuals, who hold the largest block of utility stock which may be affected by the proposal, will suffer the most harm, as the market value of their shares declines and their ownership positions are diluted by increased issuance of common stock. Moreover, while simplification of the tax law is a laudable goal, public utilities undoubtedly are willing to bear the burden of maintaining records necessary to establish qualification for return of capital treatment.

The Staff's proposed three-pronged exception to denial of return of capital treatment does not afford a reasonable or workable solution to the harshness of the elimination of the earnings and profits limitation on public utilities. As a conceptual matter, the exception is unsatisfactory, because it treats distributions differently based on the identity of the shareholder rather than on the nature of the distributions. As a practical matter, the three-year limit does not serve the needs of the public utility industry, as more than three years often are required to construct new electric generation facilities.

Moreover, because the exception applies only to original contributors, the stock will be worth less to subsequent purchasers. The resulting reduction in liquidity for the common stock will increase utilities' costs of issuing new common stock, which costs will be passed on to consumers. In any event, administration of this relief provision would be burdensome with respect to corporations having thousands of shareholders.

We propose that the Committee pursue a series of remedies aimed at specific problems rather than endorse the proposed radical change, which would dramatically impact the capital-raising activities of public utility companies. We would welcome an opportunity to work with the Committee in this effort. Grandfathering stock issued before the effective date of the legislation to avoid massive reductions in the value of outstanding stock may not be a viable suggestion, due to the complexities of trading, reporting and record-keeping in the public utility industry. Therefore, harsh impacts on the public utility industry can be avoided only by abandoning the proposed change.

III. Description of Return of Capital Distributions in the Public Utility Industry

A. Investors

Sale of stock on which return of capital treatment is expected appeals to individual investors, who are not eligible for the 85% dividends received deduction. As a result, they own the majority of public utility stock subject to return of capital treatment. Under current law, investors reduce their basis in the stock by the amount of distributions received which were not made from earnings and profits, thereby avoiding current tax at ordinary income rates of up to 50%. Distributions in excess of tax basis generally result in capital gains when received. Return of capital treatment increases potential gain or decreases potential loss upon sale, with resulting tax costs of up to 20% of the distributed amount in the case of long-term gains and 50% in the case of short-term gains. The ability to eliminate current tax and ultimately to pay tax at a lower rate has caused individual investors to accept a lower pre-tax return on public utility common stock than they would for stock producing taxable dividends.

Corporations have had little incentive to invest in equities paying return of capital dividends. The 85% dividends received deduction available to corporate investors reduces the effective tax rate on dividends they receive to 6.9%. In contrast, as a result of the reduction in stock basis, return of capital treatment may well cause corporate investors to realize greater capital gains upon sale of the stock. These gains would be taxed at a higher rate, 28% if long-term and 46% if short-term.

B. Public Utility Issuers

Public utilities, especially electric utilities, rely on sales of common and preferred stocks plus long-term debt to finance new construction. The return of capital characteristic is a major marketing factor and produces higher demand for public utility stock than would otherwise exist. As described in greater detail in our previous statement, the level of debt in a public utility's capital structure is limited by investor and rating agency guidelines which take account of ratios of equity to debt. A public utility often issues preferred or common stock to preserve its ability to issue additional long-term debt at an acceptable rate of interest, while maintaining its desired credit rating. Since 1981, electric utilities alone have raised nearly $7.2 billion through public sales of common stock, of which 68.1% was raised by companies at least a portion of whose dividends represented a return of capital. In total, about 21% of all dividends paid by electric utilities on common stock were received on a return of capital basis. Additionally, return of capital dividends were paid on preferred stock of some of these companies. Many of these utilities plan to raise a sizeable amount of equity capital to complete on-going construction programs. The ability to rely on return of capital dividends has lowered financing costs to eligible public utilities, with a consequent reduction in rates charged to their customers, since savings in large part are passed on.

Public utilities often qualify for return of capital treatment because of their extensive capital projects. Financial accounting rules prescribed by state and federal regulatory bodies for public utilities establish an allowance for a hypothetical investment return on funds used during construction ("AFUDC") prior to the time a new facility is placed in service.* Generally accepted accounting principles treat AFUDC funds as earnings but for tax purposes these hypothetical returns on funds invested to construct new plants are not income. Consequently, a public utility can report book income, even though it has minimal earnings and profits or a deficit for tax purposes. It is appropriate to treat distributions made by these companies as non-taxable returns of capital, because AFUDC represents neither real cash flow nor the accrual of a right to future income.

For some public utilities, a very high proportion of financial income stems from AFUDC due to expanding construction programs. For example, 83% of the financial income of the major electrical utilities which in 1982 paid return of capital dividends was represented by AFUDC; for the electric industry as a whole, during the last twelve months 59% of earnings were from this hypothetical source.

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* AFUDC is added to a utility's rate-making base upon which public utility commissions allow a rate of return. The rate may vary from time to time based upon commission decisions.

Investors who supply construction funds to these companies receive distributions on their investment from general corporate funds, not from true earnings. In fact, many regulatory commissions refuse to permit a current return on these funds during the construction period. Thus, no abuse exists with regard to these distributions.

IV. Impact of Proposed Change on Investors and Issuers

A. Investors

Under the proposed change, individual investors would be subject to tax at ordinary income rates on all distributions other than those in redemption of stock or for which the exception applies. If the earnings and profits limitation were abolished, in many cases investors who are in reality receiving funds representing return of capital would be taxed at ordinary rates, which we believe to be inequitable.

To compensate for the imposition of current tax at ordinary rates, investors would demand higher yields on common stock issues whose dividends previously had been treated as return of capital. This would result in lower prices for outstanding shares, leading to capital losses or decreased capital gains for current shareholders. While it would be desirable to quantify the increase in required market yields, it is difficult to produce accurate numbers at this time. However, our sense is that the price decline needed to raise the market yield to an acceptable level would be significant.

B. Public Utility Issuers

If the return of capital rule were eliminated, public utilities would be forced either to meet shareholders' demands for a higher return on new issues of common stock or to place greater reliance on the issuance of preferred stock or debt. Issuing companies wishing to continue reliance on common stock in financing their construction programs would be forced to sell bigger issues to raise the same amount of funds. Higher utility rates would be necessary to support the enlarged equity base. Sale of preferred stock by such companies could be prohibitively expensive or even impossible in certain instances. Increased sale of debt would not be a complete solution for financing needs because of its impact on credit ratings, which in turn would result in higher costs, as detailed in our earlier statement. For example, of the 16 companies which raised common stock in 1982 and whose dividends were accorded return of capital treatment, 14 have senior debt ratings of BBB or below, the lowest rating required to qualify as investment grade securities. Increased issuance of debt securities could cause further deterioration in credit ratings, which would not only increase debt service costs but also would eliminate as a capital source certain institutional buyers who are permitted to purchase only investment grade securities. In addition to influencing credit ratings, greater leverage in a corporation's financial structure and consequent increases in debt service charges result in greater corporate vulnerability to adverse economic events.

It should be noted that Congress already has restricted the ability of public utilities to pay return of capital dividends. As a result of the Tax Reform Act of 1969 and subsequent conforming legislation, depreciation deductions must be calculated on a straight-line basis for the purpose of computing earnings and profits. We believe this change has limited public utilities' ability to pay return of capital dividends to appropriate situations.

V. Adoption of Financial Income Standard

It has been suggested that in lieu of the Staff proposal the Committee substitute financial accounting methods, presumably generally accepted accounting principles ("GAAP"), for the calculation of earnings and profits. This would be disastrous for many public utilities. The inclusion of AFUDC in current income under GAAP would yield taxable dividends from current earnings even though the income is hypothetical and the distributions in reality represent return of capital on invested funds.

The adoption of GAAP as principles of tax law would introduce a new element of uncertainty into the determination of the tax treatment of corporate distributions. GAAP varies over time and is often the subject of substantial disagreement within the accounting profession. Presumably courts would be relied upon to resolve differences in interpretation, but it is unclear what standards courts would use in determining financial income if the principle in dispute were the subject of contention among accountants.

It is far from clear that the adoption of GAAP would be appropriate as a matter of public policy. The principles underlying GAAP are intended to portray to interested parties the fiscal health of a business enterprise, a concept different from and often irrelevant to tax concerns, *e.g.*, the need to raise revenue efficiently and equitably. In fact, transitional rules necessary if financial income were substituted for the earnings and profits limitation could well create additional complexity rather than simplicity in the tax system.

VI. Conclusion

For the reasons set forth above, we do not believe that the Staff proposal should be adopted. The current rules do not afford holders or issuers of equity securities unintended tax benefits in the vast majority of cases. Any questionable practices that may occur in non-utility industries should be addressed by solutions tailored to those instances. The proposed change, if adopted, would have adverse effects upon the public utility industry and upon holders of outstanding public utility stock who legitimately have relied upon long-standing provisions of federal tax law.

FLORIDA POWER & LIGHT COMPANY

October 27, 1983

Mr. Roderick A. DeArment, Chief Counsel
Committee on Finance
Room SD 219
Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. DeArment:

Comments are hereby being submitted on behalf of Florida Power & Light Company (FPL) concerning one proposal of the preliminary report of the Senate Finance Committee Staff on "Reform and Simplification of the Income Taxation of Corporations."

FPL is an investor-owned electric utility, serving approximately 24 million customers in Florida. The outstanding equity of FPL has a market value in excess of $2 billion. FPL appreciates the opportunity to submit written comments on this preliminary report.

The proposal of major concern to FPL is the extension of the holding period for the dividends received exclusion and the limitation of the deductibility of interest expense used to purchase or carry stock producing dividends eligible for the dividends received exclusion.

The purpose of the 85% dividend exclusion was to partially eliminate the multiple taxation of the same income at the corporate level. Without the dividend exclusion, income would be taxed initially by "A" corporation which earned the income, a second time by "B" corporation which received a dividend from "A" corporation, and again when the stockholders of "B" corporation receive a dividend. Fortunately, Congress recognized the adverse impact of multiple taxation at the corporate level and allowed corporation "B" to exclude from taxable income 85% of the dividend received from corporation "A" if corporation "B" held the stock of corporation "A" for at least fifteen days.

The present proposal is a clear step backward in the area of corporate taxation. In an attempt to limit certain abuses, the Staff has proposed increasing the holding period from fifteen days to one year and not allowing a deduction for 35% of the interest expense used to buy or carry the stock.

The extension of the holding period to one year will eliminate many corporate investors desiring liquidity. Liquidity is an essential element of the financial markets in the present economic conditions. To place burdensome tax constraints on liquidity will cause corporate investors to seek other investments, thereby increasing the cost of capital of the company. This would have a deletorious impact on the stock value of other investors. FPL recommends that the present fifteen-day holding period be retained; however, if this is not possible, FPL recommends a forty-five day holding period.

The disallowance of 85% of the interest expense used to finance stock paying dividends eligible for the exclusion would be poor tax policy. First, this proposal would endorse multiple taxation of income at the corporate level. Second, the disallowed interest expense would exceed the dividend exclusion in many cases. FPL is opposed to multiple taxation of the same income and believes that this proposal would also increase the cost of obtaining capital. For these reasons, FPL urges that the proposal to disallow 85% of the interest expense should be deleted.

Sincerely,

Gary G. Kuberek
Assistant Comptroller

sas

GENERAL MOTORS CORPORATION
General Motors Building • 767 Fifth Avenue, New York, New York 10153

Telephone
(212) 486-5000

October 28, 1983

Mr. Roderick A. De Arment
Chief Counsel, Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D. C. 20510

RE: Finance Committee Hearing on Taxation (10/24/83)

Dear Sir:

As the Director of investments for an insurance company group with $97 million of preferred stocks, I would like to take this opportunity to add my voice to those responsible members of the investment community who are opposed to the current proposal, on the Senate Finance Committee's agenda, which would eliminate the 85% dividend exclusion on the income received from issues sold within one year of the date of purchase. In my opinion, such proposed change is ill advised and, if adopted, would generate several unnecessary and definitely undesirable results for both current holders of dividend paying investments and for prospective issuers of such investments.

For the current holders of such investments, elimination of the 85% dividend exclusion on the income received from issues sold within one year of the date of purchase would trigger a decline in the market value of each dividend paying investment because a potential buyer would require a much higher expected rate of return from the seller (in the form of a lower market price where the dividend is stable, as is the case for most preferred stocks), so as to be able to achieve his expected rate of return, regardless of when he decided to sell his holdings. This is so because the dividends received could represent income to be taxable at the 46% rate until the passage of the one year holding period at which time such income would be subject to the 85% exclusion. Stated another way, the prospective purchaser will demand compensation for the extended period he may be at risk and this compensation, for outstanding securities, will come in the form of reduced market prices (generating higher yields) which will adversely impact current holders of such securities.

Going one step further, for new issues all dividend rates (especially for those preferred stocks where the dividend rate is fixed) will have to be set at much higher levels in order to attract investors. This increased expense will make it more difficult for business, in general, to raise equity capital for its current and future growth needs and would be particularly burdensome for the utility industry, a major issuer of preferred stocks.

I would also like to offer two other points. First of all, it would appear that the proposed change would present an accounting nightmare in those instances where dividends received in a calendar year are given the preferential tax treatment, but the securities are sold in the following calendar year before the passage of the one year holding period. This will require at a minimum, a restatement of the company's prior year's earnings and taxes payable, etc. Secondly, any change that would result in a reduction in the asset values of insurance companies (which are major holders of preferred and common stocks) would reduce this industry's ability to offer insurance coverages and would place an additional, unexpected burden on all insurance regulatory authorities charged with monitoring the solvency of such companies.

For these reasons, I recommend that no change be made to the current 15 day holding period to receive the 85% dividend exclusion.

I trust that my comments, and those of the investment community, will be given consideration in your Committee's difficult task of exploring revenue options.

Very truly yours,

Donald J. Haig

Donald J. Haig,
Director of MIC Investments
Investment Funds Activity

DJH:mag

STATEMENT OF
DAVID G. GLICKMAN, ESQ.

Johnson & Swanson
4700 InterFirst Two
Dallas, Texas 75270
(214) 653-2000

before

THE COMMITTEE ON FINANCE
UNITED STATES SENATE

on

HEARING ON PRELIMINARY REPORT ON THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS

DATE OF STATEMENT
November 2, 1983

DATE OF HEARING
October 24, 1983

Mr. Chairman and Members of the Committee:

My name is David G. Glickman. I practice law in Dallas, Texas with the firm of Johnson & Swanson. My firm represents May Energy Partners, Ltd. and Snyder Oil Partners, each of which is a publicly traded limited partnership engaged in oil and gas exploration and development activities, and a third oil and gas limited partnership expected to be formed early next year. Each of our clients has (or will) become a publicly traded limited partnership by issuing limited partnership interests in exchange for oil and gas properties and interests in oil and gas partnerships.

Our concern is directed toward the proposal (the "Proposal"), discussed in paragraphs I.D.5., II.G., III.E., IV.F., and V.E. of the Staff's Preliminary Report entitled "The Reform and Simplification of the Income Taxation of Corporations" (the "Report"), that would classify publicly traded limited partnerships as associations taxable as corporations. Although the hearing on this issue was held on October 24, 1983, the published notice of the hearing (Press Release 83-186) states that written statements regarding the Proposal will be accepted no later than November 2, 1983. Accordingly, on behalf of our clients and pursuant to the notice of the hearing, I am submitting this written statement for consideration by the Senate Finance Committee (the "Committee").

I. Arguments Advanced In Support Of The Proposal

According to the Report, two arguments have been advanced in favor of the Proposal: (i) "publicly traded limited partnerships are simply too similar to business entities that are taxed as associations," and (ii) the partnership tax rules cannot work effectively for publicly traded limited partnerships. Apparently, this latter concern relates to compliance with the Federal income tax laws by publicly held limited partnerships and their partners. In addition, since the Report cites a recent article in Forbes magazine (the "Forbes Article") which implies that public trading of limited partnership interests will lead to the conversion of large numbers of corporations into partnerships (see Mack, Disincorporating America, Forbes (August 1, 1983) at 76), it appears that proponents of the Proposal are concerned that the continued treatment of publicly traded limited partnerships as partnerships for Federal tax purposes will lead to the "disincorporation of America" and a substantial loss of revenues. My comments will be directed primarily to the substantive issue of whether publicly traded limited partnerships are, in fact, "too similar" to business entities taxable as corporations and to the practical and policy implications of the Proposal.

II. Summary Of Comments

The Proposal should be rejected for the following reasons:

(i) Given the myriad of traits that may affect the classification of a business organization for Federal tax purposes, the classification of business entities should remain with the courts and the Executive Branch in accordance with well-conceived standards of universal application and should not be undertaken by Congress on a case-by-case basis.

(ii) Public trading of interests is an extrinsic characteristic of organizations that has nothing to do with the relationship of the members to each other or of the members to the organization. A partnership is no less a partnership because its interests are bought and sold, just as a public company is no less a corporation when its stock ceases to be traded. Therefore, public trading of interests is not a distinguishing corporate characteristic and should be irrelevant to the determination of whether a business entity constitutes an association taxable as a corporation.

(iii) If there is concern with the methodology by which the existing classification regulations draw the line between "true" partnerships and associations, then a careful and thorough study of the standards is required. If anything, new standards of universal application, not expedited legislation that is targeted to a narrow cross-section of business entities, should result from this study.

(iv) Compliance with the Federal income tax laws applicable to partnerships and partners has been greatly facilitated by the enactment of the partnership audit and procedural rules of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), coupled with the use of sophisticated accounting software developed by publicly traded limited partnerships. Accordingly, I believe that the Department of the Treasury ("Treasury"), in its testimony before this Committee, was accurate in stating, "[t]hese . . . problems are faced to a greater or lesser degree by every partnership and we are not convinced that [they] are insuperable."

(v) Finally, in light of the operational differences between corporations and partnerships and the tax and other costs that would be incurred in converting a corporation into a partnership, it is difficult to see how a loss of revenues will result from the continued classification of publicly traded limited partnerships as partnerships for Federal tax purposes.

III. The Definition Of "Association"

Superficially, the Proposal appears to be a manifestation of a bias in favor of the two-tiered taxing structure of Subchapter C of the Code1/ over the integrated taxing structure

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1/ Unless otherwise stated, the term "Code" means, and all section references are to, the Internal Revenue Code of 1954, as amended.

of Subchapter K of the Code. Upon closer examination, however, it is apparent from the restricted scope of the Proposal that it is not founded on such a general premise, but rather is based primarily upon the proposition that public trading of interests is a corporate characteristic that should, regardless of the presence or absence of other corporate traits, result in the classification of a limited partnership as an association taxable as a corporation. As discussed hereinafter, it is ill-advised, as a matter of legislative policy, to attempt to classify organizations by ad hoc legislation rather than to permit the courts and Executive Branch to make such determinations in accordance with a rational methodology of universal application. Furthermore, it is submitted that public trading of interests is not a corporate characteristic that should be considered in determining the classification an organization.

A. Congress Should Not Attempt To Classify Business Organizations On A Case-By-Case Basis

Since the Income Tax Act of 1894 (28 Stat. 556), the Code and its predecessors have afforded taxpayers a choice between taxable entities (namely, corporations and "associations") and "conduit" entities (namely, general and limited partnerships), and has left the task of defining or classifying such entities to the courts and the Executive Branch. See, I Seidman's Legislative History of Federal Income Tax Laws 1020, 21 (1938);

Flint v. Stone Tracy Co., 220 U.S. 107 (1911). By delegating the task of defining associations to the courts, Treasury, and the Internal Revenue Service (the "Service"), it appears that Congress concluded, as the Supreme Court later stated, that "[i]t is impossible in the nature of things to translate the statutory concept of 'association' into a particularity of detail that would fix the status of every sort of enterprise or organization which ingenuity may create . . . ." Morrissey v. Commissioner, 296 U.S. 344, 350 (1935).

Presently, the Committee is addressing the propriety of classifying a narrowly restricted group of limited partnerships as "true" partnerships rather than as associations taxable as corporations. At some future time, perhaps some other particular business organization will be questioned. In essence, the question is not merely whether publicly traded limited partnerships should be taxed as corporations; rather, the question also involves the broader policy consideration of whether it is advisable for Congress to determine, on a case-by-case basis, the Federal tax classification of a specific business organization, or whether such determinations are better left to the courts and the Executive Branch based upon logical distinctions formulated in an orderly fashion over time.

Given the variety of traits that a business organization may possess and the administrative inefficiency that would result if it is left to Congress to determine the Federal tax classification of specific organizations on a case-by-case basis, Congress should not embark upon this path.

B. A Limited Partnership Does Not More Nearly Resemble A Corporation Than A "True" Partnership Merely Because Its Interests Are Publicly Traded

Any decision made by the Committee with respect to the Proposal should be based upon a well conceived, rational methodology for classifying entities and not upon a vague feeling or belief that a publicly traded limited partnership "walks and talks like a corporation." See the Forbes Article. It is submitted that the first step in applying a rational means of determining the Federal tax classification of a specific form of enterprise is to ascertain whether the organization possesses traits that are intrinsic to _de jure_ corporations.

In _Morrissey v. Commissioner_, _supra_, the Supreme Court, addressing the question of whether a trust should be classified as an association, first identified the characteristics that, in its view, should be considered in determining whether an organization is an association. Although the corporate characteristics enumerated by the Court in _Morrissey_ may not be exhaustive of the traits shared by all _de jure_ corporations, such characteristics are certainly significant corporate traits that should be taken into account by any rational classification system. According to the Court in Morrissey, a sine qua non of association status is that the organization be comprised of "associates" who have joined together to conduct an enterprise for profit. Other factors considered by the Court were:

(i) the limitation of liability for the debts of the organization to the property of the organization, with no recourse to the properties of its beneficial owners;

(ii) the ability to transfer beneficial interests in the organization without destroying the continuity of the enterprise, and the opportunity for continuation of the enterprise without interruption by the death of a beneficial owner;2/ and

(iii) the opportunity for centralization of management in representatives (who need not be owners of beneficial interests in the organization).

2/ It should be noted that the Court in Morrissey seems to have viewed "free transferability of interests" and "continuity of life" as a single, inseparable corporate trait. As discussed below, subsequent courts viewed these as two distinct characteristics.

In 1960, primarily in response to the taxpayer's victory in United States v. Kintner, 216 F.2d 418 (9th Cir. 1954), Treasury promulgated the current regulations under section 7701 of the Code governing the determination of whether an organization should be classified as a trust, a partnership, or an association for Federal tax purposes. See Treas. Reg. § 301.7701-2. These regulations adopt and refine the criteria set forth in the Morrissey case. In general, the regulations provide that an organization will be taxed as a corporation for Federal tax purposes if (i) the organization is comprised of associates who have an objective to carry on a business or financial enterprise and divide the gains therefrom, and (ii) the organization possesses at least three of the following characteristics: (a) continuity of life, (b) centralization of management, (c) limited liability, and (d) free transferability of interests. Treas. Regs. §§ 301.7701-2(a)(1) and 301.7701-2(a)(3). Since the promulgation of these regulations, the courts have generally followed the classification scheme adopted by Treasury. See Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975); Phillip G. Larson, 66 T.C. 159 (1976); cf. Outlaw v. United States, 494 F.2d 1376 (Ct. Cl. 1974).

Clearly, publicly traded limited partnerships (just as privately held limited partnerships) are composed of "associates" who have an objective of carrying on a financial enterprise and dividing the gains therefrom. However, such publicly traded limited partnerships (as is the case with most privately held limited partnerships) have been carefully structured such that they lack at least two of the corporate characteristics of continuity of life, centralization of management, limited liability, and free transferability of interests; as such, these limited partnerships are not classified as associations taxable as corporations under the current regulatory application of the Morrissey test.

Since the Proposal would classify a publicly traded limited partnership as an association taxable as a corporation even though it is identical in all other respects to a privately held (or, for that matter, publicly held but not traded) limited partnership that will continue to be classified as a partnership, it appears that the proponents of the Proposal must believe either that public trading of interests, per se, is a controlling corporate trait, or that public trading of interests results in, or is symptomatic of, the existence of a controlling corporate trait. Public trading of interests, per se, may be viewed as a controlling factor for classification purposes only if it is a trait intrinsic to corporations. While it is true that the overwhelming majority of interests traded on our securities markets are stock and debt securities of corporations, it is also true that the overwhelming majority of corporations are privately owned corporations whose stock is at least as illiquid as interests in their closely held partnership counterparts. In addition, there are numerous privately owned partnerships and corporations whose interests are highly liquid by reason of puts, redemption provisions, and market clearing arrangements (which do not constitute "established securities markets" under any definition of the term). Liquidity or ready marketability of interests is in fact dependent upon circumstances that are extrinsic to the relationship of the members to the organization or of the members to each other. Accordingly, public trading of interests, _per se_, simply is not a trait that is intrinsic to corporations, hence should be irrelevant to the determination of whether a business organization should be classified as an association taxable as a corporation.

Notwithstanding the foregoing, the Proposal might be logically supportable if it were grounded on the proposition that public trading of interests results in, or is symptomatic of, an intrinsic corporate trait that should be afforded controlling significance for classification purposes. The only intrinsic corporate trait that appears to bear any resemblance or relation to public trading of interests is the trait of free transferability of interests.

In Morrissey, the power (or legal right) to transfer an interest without ending the existence of the organization was held to be a corporate characteristic. Subsequently, the courts refined this concept and held that free transferability of interests is a separate trait that exists if the transferee of an interest in the organization is substituted to all rights and powers of the transferor vis-a-vis the organization. See Glensder Textile Co., 46 B.T.A. 176 (1942). It is submitted that this trait of "free transferability of interests" is common to all de jure corporations, hence is a proper criterion to consider in determining whether an organization should be classified as an association taxable as a corporation.

Most (if not all) publicly traded limited partnerships possess the Morrissey-Glensder Textile trait of free transferability of interests, as reiterated in Treas. Reg. § 301.7701-2(e). However, there are also many non-traded limited partnerships possessing the trait of "free transferability" which would not be classified as associations under the Proposal. It is therefore clear that the trait of "free transferability" is not dependent, in whole or in part, upon the public trading of interests, and that the Proposal cannot be based upon the theory that such "free transferability" is a corporate characteristic that, in the case of limited partnerships, should be controlling for classification purposes.

It is possible that the concern with public trading of interests reflects an underlying discomfort with the size of publicly traded limited partnerships or the similarity of their interests to stock. Although the label of corporation is commonly associated with the concept of large enterprises (or "big business"), it is submitted that size (whether measured in terms of asset values or number of participants) should not be a relevant consideration for purposes of determining the Federal tax classification of an organization. If two or more individuals wish to pool their assets in the conduct of a business, they should have the right to choose between the provisions of Subchapter K and those of Subchapter C, regardless of the value of those assets. Similarly, the number of participants in an enterprise is not an intrinsic corporate trait, hence should not be relevant to the determination of the Federal tax status of an organization. A one-shareholder corporation is no less a corporation than a publicly held corporation. In any event, the Proposal, by its terms, is not targeted to all "large" partnerships, since it would not revoke the partnership status of large, publicly held (but not traded) limited partnerships.

Insofar as the similarity of limited partnership interests and stock is concerned, there is no doubt that limited partners and stockholders have similar rights and obligations. Indeed, in 1822, the first limited partnership act was enacted expressly to permit "silent" partners to contribute capital to a partnership while having a position analogous to that of a stockholder. See, generally, 60 Am Jur 2d at p. 253. However, since the similarity exists regardless of the numbers of limited partners and stockholders or the existence of an established market for interests, it is not a reason to distinguish between publicly traded and other limited partnerships and, accordingly, cannot be an argument supportive of the Proposal.

To summarize, the only significant difference between publicly traded limited partnerships (which admittedly possess the intrinsic corporate trait of "free transferability" of interests) and many other limited partnerships (which, although not publicly traded, also possess the trait of "free transferability" of interests) is the existence of an established market for interests. Since the existence of an established market for interests is not a distinguishing characteristic of corporations, it would be unjustifiable for Congress to enact legislation that will draw an artificial and irrational distinction between publicly traded limited partnerships and functionally identical limited partnerships whose interests are not traded.

C. Revision Or Replacement Of Existing Standards

The Proposal may stem partially from concern with the line currently drawn by the regulations under section 7701 between "true" partnerships and associations taxable as corporations. It might be argued that the existing regulations under section 7701 manifest an overreaction to the Kintner decision and do not apply a sound methodology for determining association status. However, even assuming arguendo that the existing regulations under section 7701 are not sound, it would not be an appropriate reaction for Congress to enact legislation that arbitrarily draws the line based upon trading of interests; rather, Congress or Treasury would be better advised to consider the adoption of new standards having universal application, or the revision of existing standards. In so doing, Congress or Treasury must be aware that it will be disrupting a balance between "conduit" business entities and taxable business entities that has been in existence since 1960. Such disruption requires careful and thorough deliberation of problems and policies far more extensive than those considered by the proponents of the Proposal, and is not a matter for expedited legislation.3/

3/ As Treasury and others have pointed out to this Committee, the use of limited partnerships taxable under Subchapter K of

[Footnote cont'd]

IV. Operation of Partnership Tax Rules

The second argument advanced in favor of the Proposal is that the partnership tax rules cannot work effectively for publicly traded limited partnerships. The administrative problems typically associated with publicly traded limited partnerships are principally the difficulty in allocating various tax items among numerous partners where there are multiple transfers of interests during the taxable year and the possibility for tax avoidance where interests are held in street name.

It is my understanding that both the allocation and street name problems have been substantially reduced by the TEFRA partnership audit rules and by the use of sophisticated accounting programs that have been developed by publicly traded limited partnerships. In addition, the reporting requirements imposed upon publicly traded limited partnerships and the

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[Footnote cont'd from previous page]

the Code is very important (if not critical) to the flow of capital into the natural resource exploration, research and development, and housing development industries. Any revisions of the association standards that might reduce the flow of capital into these industries must be scrutinized thoroughly. Other problems and policy considerations include (i) whether it is advisable to broaden, narrow, or eliminate the two-tiered tax regime of Subchapter C and (ii) the tension that will be placed upon the classification issue if the Subchapter C proposals recommended in the Report are enacted.

public scrutiny that these partnerships receive would seem to make them less likely to engage in tax avoidance activities than partnerships which are not publicly traded. Accordingly, I believe that Treasury, in its testimony before this Committee, was accurate in stating, "[t]hese . . . problems are faced to a greater or lesser degree by every partnership and we are not convinced that [they] are insuperable."

V. The Impediments To "Disincorporating" America

Concern, stemming principally from the Forbes Article, has been expressed that, if publicly traded limited partnerships continue to be classified as partnerships for Federal tax purposes, soon many large corporations will be "disincorporated" into publicly traded limited partnerships, resulting in a substantial loss of revenues. For the following reasons, it is difficult to see how a significant loss of revenues will result from the continued classification of publicly traded limited partnerships as partnerships for Federal tax purposes.

A. Tax And Financial Impediments To "Disincorporation"

There appear to be only three generic methods (albeit, with many variations) by which a large corporation may be "disincorporated," within the meaning of the Forbes Article. One method would be for the corporation to completely liquidate and transfer its assets to a newly created or existing limited partnership. For most profitable corporations, the tax costs (in the form of capital gain tax at the shareholder level and recapture tax at the corporate level) of a complete liquidation would be substantial, if not prohibitive. 4/ Of course, for a few corporations that have incurred substantial economic losses and that possess significant net operating loss carryovers and other tax benefits, such a complete liquidation might be implemented without significant tax costs at the corporate or shareholder level. However, such loss companies comprise only a small portion of the universe of publicly traded corporations. Also, since such a complete liquidation of a loss corporation would result in the elimination of its tax benefits, there is a strong tax disincentive for completely liquidating. Thus, it seems highly unlikely that many large corporations would be completely liquidated into publicly traded limited partnerships.

Perhaps another method for "disincorporating" a corporation would be for the corporation to contribute all or a

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4/ Theoretically, a complete liquidation under section 333 of the Code might be employed to avoid substantial Federal income tax at the shareholder level. However, for a variety of reasons, this alternative is not a practical means of "disincorporating" for most large corporations whose stocks are publicly traded.

portion of its business to a limited partnership and raise capital for that business by selling limited partnership units to the public. Since a portion of the operating revenues of the partnership would be diverted from the corporation to the new partners, there is clearly a financial disincentive for raising capital by selling partnership units to the public. It is submitted that, absent significant dilution of their existing shareholders, most corporations normally would prefer to raise capital by issuing new stock and thereby retain the operating revenues generated by the new capital. Furthermore, such conversion of an existing corporation into a partnership is not really a "disincorporation" of existing corporate earnings, since only the earnings attributable to the new capital contributed by the limited partners would be taxed to the new partners.

The third method for "disincorporating" a corporation would be for the corporation to contribute a portion of its assets to a limited partnership and then distribute limited partnership interests to its shareholders as a dividend or in redemption of stock. After TEFRA, any such distribution of limited partnership interests which results in capital gain to the distributee shareholders generally will result in corporate level tax under section 311(d)(1) of the Code, subject to certain very narrow exceptions. If this corporate level tax is not incurred by reason of the distribution, then the distribution generally will result in dividend income to the shareholders to the extent of the distributing corporation's earnings and profits. Thus, as in the case of the complete liquidation of a corporation, this method of piecemeal conversion into a partnership in most cases would result in substantial tax burdens at the shareholder and/or corporate levels.

Finally, if the Subchapter C proposals recommended in the Report are enacted by Congress, then the tax disincentives for converting an existing corporation into a partnership will be even greater. There would then be no means of avoiding corporate level tax upon distributions of assets or partnership interests.

B. Operational Impediments To "Disincorporation"

In addition to the tax and financial impediments to "disincorporating," there are at least two significant operational distinctions between a limited partnership and a de jure corporation which, in theory and in practice, provide disincentives to conducting many businesses in limited partnership form. These disincentives will limit the conversion of existing corporations into limited partnerships and, in addition, will often cause a founder of a business to conduct the business in corporate, rather than limited partnership, solution.

The first significant operational distinction between a limited partnership and a de jure corporation is that, under virtually all state laws, a limited partnership must have a limited term of existence, whereas a corporation may exist perpetually. Limited partnerships always have a specified termination date and are terminated earlier upon the bankruptcy, liquidation or death of the general partners. The stated term of existence is often 50 years. It is possible that this term could be extended as the termination date draws near. In addition, the partnership agreements of most publicly traded limited partnerships have provided for multiple or substitute general partners, or other makeshift solutions, so as to continue business after the bankruptcy, liquidation or death of a general partner. In both cases, however, limited partner approval of the continuation of the partnership is ultimately required, and it is quite possible the limited partners would not elect to continue the partnership. In the corporate context, shareholder approval is required to terminate; in the limited partnership context, limited partner approval is required to continue in existence. This distinction affords a corporation significantly greater assurance of continuation than is afforded to a limited partnership.

The implications of a limited, and uncertain, term of existence will have their strongest effect as the termination date draws near. Since most limited partnerships have had limited business purposes, and publicly traded limited partnerships are relatively young, examples of difficulty doing business in the face of imminent termination are limited. The person considering conducting business in limited partnership or corporate form must nevertheless deal with the implications of a limited term of existence, particularly if the limited partners' interests are to be publicly traded. As the termination date approaches -- even 10 or more years before termination -- the business may be expected to encounter difficulties raising additional capital and taking advantage of opportunities which require long-term commitments. Throughout the term, the limited partnership will be more likely to hold assets which are readily saleable so that values recognized in liquidation would be less uncertain.

The difficulties resulting from a limited term of existence may not appear great. However, as a practical matter, all but the most shortsighted persons will be influenced by this limited partnership trait. Certain activities may well be conducted despite the limited term of existence. Ownership of producing oil wells and real estate, for instance, do not usually require periodic infusions of additional capital and the assets owned may be liquidated with relative ease and certainty. Other activities, however, could be severely handicapped, particularly if they can be expected, as is the case with most industrial organizations, to require substantial capital to replace or upgrade facilities or are required to enter into long term projects in order to provide for future growth.

The second significant operational distinction between a limited partnership and a de jure corporation is that the general partners of a limited partnership are liable for all obligations of the limited partnership, whereas management and owners of a corporation are not individually liable for corporate obligations. Thus, in order to conduct any business in limited partnership solution, the general partners (whether corporations or individuals) must be willing to assume unlimited liability in the event of failure. This difference is profound, and will further limit the desirability of doing business in limited partnership form. This is particularly true for ventures which require high levels of indebtedness and/or face uncertain futures.5/ It is not mere coincidence that limited

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5/ Even corporations embarking on or purchasing speculative or highly leveraged businesses will wish to further limit their exposure by conducting the business through corporate subsidiaries.

partnerships have primarily engaged in limited purpose businesses where the risk of failure is contained to loss of the partners' contributions. Although publicly traded limited partnerships may have broader business purposes, to date every publicly traded limited partnership commenced its business with a substantial base of revenue generating assets and (subject to the single exception of real estate ventures which typically employ high levels of well-secured debt) a relatively low debt level. In conducting their businesses, publicly traded limited partnerships have as a rule restricted their operations to those which could be financed primarily from current cash flow.

It is submitted that these two distinctions between corporations and limited partnerships - limited life and unlimited liability of the general partners - are, in fact as well as in theory, crucial and important differences. Indeed, perpetual life and limited liability are the two reasons corporations came into being and have become the preferred method of conducting business. For very real reasons, it is submitted that the role of the limited partnership is likely to remain limited primarily to those types of business that have limited goals and identifiable (and containable) business risks.

VI. Conclusion

For the reasons discussed above, the Proposal should be rejected. If the Committee is concerned that the current classification regulations may not properly draw the line between "true" partnerships and associations taxable as corporations, then a project should be initiated to study the problems and make recommendations targeted to the improvement of existing standards (if they are found lacking) or development of new standards having universal application.

MCCORMICK OIL & GAS COMPANY
TWO ALLEN CENTER, SUITE 3800
HOUSTON, TEXAS 77002
AREA CODE 713 658-8031

November 1, 1983

Mr. Roderick A. DeArment
Chief Counsel
Committee on Finance
United States Senate
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Finance Committee Hearing on Report on Reform of Corporate Taxation - October 24, 1983

Dear Mr. DeArment:

In S. Prt. 98-95, The Reform and Simplification of The Income Taxation of Corporations (September 22, 1983) ("Preliminary Report"), the Senate Finance Committee Staff ("Staff") recommended that, among other things, limited partnerships with publicly traded partnership interests should be taxed as corporations (hereinafter the "Proposal"). On October 4, 1983 a hearing on the Preliminary Report was announced, and specific comment was requested by Senator Dole on the issue of whether "inactive limited partnerships with publicly traded partnership interests" should be taxed as corporations (the "Announcement"). Pursuant to that Announcement, a hearing was held by the Senate Finance

Committee on October 24, 1983 (the "Hearing"), at which various issues with respect to the Proposal were discussed.

This letter is intended to serve as our written statement for inclusion in the printed record of the Hearing. Specifically, McCormick Oil & Gas Company wishes (i) to respond to Senator Dole's request for comments relating to the Proposal in the Announcement, (ii) to comment on certain of the matters relating to the Proposal discussed at the Hearing and (iii) to express our concerns as to the inappropriateness of the Proposal generally as well as in the context of a publicly traded partnership formed to succeed to the assets of a liquidating corporation.

Background

Description of McCormick Oil & Gas Company. McCormick Oil & Gas Company ("McCormick" or the "Company") is a Delaware corporation which was formed in 1979. The common stock of McCormick is held by approximately 10,000 shareholders and is traded in the over-the-counter market.

Since its inception, McCormick has conducted the business of exploration for and development and production of oil and gas, concentrating on developing its existing properties and on exploration for new reserves. The Company's exploration activities have been financed through the sale of limited partnership interests in McCormick's annual public drilling programs, by direct investment and by entering into joint ventures with unrelated industry investors.

The Company's Liquidation Plan. Following approximately one year of analysis, in May, 1983 McCormick management recommended to the McCormick Board of Directors that the Company (i) discontinue exploration activities and (ii) liquidate into a limited partnership which will own, develop and operate the Company's existing oil and gas properties ("Plan of Liquidation"). The Board of Directors approved the Plan of Liquidation subject to adoption by Company shareholders, and on September 13, 1983 a Registration Statement on Form S-1 was filed with the Securities and Exchange Commission with respect to the proposed transactions. On August 5, 1983 and September 6, 1983, requests for rulings with respect to various aspects of the Plan of Liquidation were filed with the Internal Revenue Service.

The Plan of Liquidation is expected to be submitted to Company shareholders for their adoption in late 1983 and, if adopted, it is anticipated that the Plan will be consummated in January, 1984. Following the consummation of the Plan, it is contemplated that the limited partnership interests in the successor partnership will trade in the over-the-counter market.

The Impact of the Proposal on the Company's Liquidation Plan. The management and Board of Directors of McCormick believe that the Plan of Liquidation is beneficial to both the Company and its shareholders. However, if the Proposal is adopted and made applicable retroactively to the Company and the successor partnership to be formed it will not be possible to consummate the Plan of Liquidation. Further, the mere threat of legislation adopting the Proposal or some form thereof has created substantial uncertainty as to whether to proceed with the Plan of Liquidation. As a practical matter, the McCormick shareholders are unlikely to approve the Plan of Liquidation when advised of the Proposal and, if enacted into law, its possible effects. Accordingly, despite substantial expenditures of time and money, it appears that the publication of the Proposal has effectively frozen the Company in a completely untenable position: it is unlikely that we can proceed with the Plan of Liquidation but any other alternative raises substantial business problems that may be insurmountable.

Perceived Justifications for the Proposal

The Staff justification for the Proposal is apparently based upon the unexamined premises that (i) publicly traded partnerships are "too similar" to corporations not to be taxed at the entity level, thus invoking the principle that tax laws should seek to achieve "neutrality", i.e., taxing like organizations alike, and (ii) there appear to be "substantial questions" with respect to whether the partnership pass-through tax rules work effectively for publicly traded partnerships, thus invoking the principle that the tax laws should be administrable. These assumptions are apparently based, at least in part, on the "tentative" position of the American Law Institute, Federal Income Tax Project: Subchapter K Tentative Draft No. 7 and an article entitled "Disincorporating America" which appeared in the August 1, 1983 edition of Forbes.

Analysis of the Proposal

As discussed below, the Staff's assumptions justifying the Proposal are simply wrong. Perhaps more importantly, in any event the Proposal represents a fundamental change in the classification of entities for federal income tax purposes and constitutes an unprecedented departure from well-accepted existing classification standards. Unlike most of the other Staff recommendations made in the Preliminary Report, the Proposal has not had the benefit of considered analysis or public comment. [1] Changes of this magnitude should not be considered, or even recommended, based upon speculative assumptions and inadequate and incomplete analyses.

Further, as noted by the Treasury in its proposed testimony at the Hearing on the Proposal, the proper tax characterization of publicly traded partnerships is inextricably linked with the issue of the characterization of all limited partnerships. Since, as discussed below, there is no reasoned basis by which publicly traded partnerships can be distinguished from non-publicly traded limited partnerships, the only appropriate forum for a proper analysis of the Proposal is in the context of a considered review of all of the entity classification rules.

1/ Although the Staff justifies the Proposal partially by reference to the American Law Institute tentative recommendations, the Institute's project reporters specifically recommended that experience with publicly traded partnerships be analyzed for "guidance" as to the effect of allowing partnership treatment to such entities. To our knowledge such analysis has not been completed or even begun.

The Neutrality Issue. The Staff concludes that publicly traded partnerships are "too similar" to corporations and thus that it is an "abuse" of the neutrality principle to not tax these partnerships at the entity level. The sole authority cited for this sweeping proposition is a nonlegal one - the Forbes article cited earlier. This conclusion fails to recognize that publicly traded limited partnerships formed under the Uniform Limited Partnership Act, as adopted in substantially all states, are partnerships for state law purposes and that there are numerous substantive, nontax differences between owning a publicly traded limited partnership interest and a publicly traded share of stock. These differences are very material to an individual's investment decision and thus an extensive discussion of such differences was included in McCormick's Registration Statement filed with respect to the Plan of Liquidation. Although a detailed comparison of the Uniform Limited Partnership Act with the various state corporation statutes is beyond the scope of this submission, some of the more obvious differences include the following:

(i) In many states, stockholders are not liable to return to a corporation any dividend or distribution therefrom except to the extent they may be liable for contribution to directors of the corporation based on allegations that stockholders knew that a dividend or distribution was in violation of applicable corporate statutes. By contrast, a limited partner who has rightfully received the return of all or part of his capital contribution may be required to repay the amount returned, with interest, to the partnership in order to discharge any partnership liabilities to creditors who extended credit or whose claims arose prior to the return of capital. Therefore an investor in a publicly traded limited partnership can have less confidence than a corporate stockholder that any distributions made with respect to his investment, whether ultimately determined to have been wrongfully or rightfully made, will not ultimately be taken from him;

(ii) A limited partner may not take part in the control of the business of the partnership without becoming liable for its debts as a general partner. By contrast, a stockholder may maintain limited liability while being integrally involved in the business of the corporation, including exercising his right to vote in elections of the board of directors of the corporation and in a variety of other matters, normally including amendment of the corporate charter or by-laws, the taking of extraordinary corporate actions, and the adoption of various compensation and incentive plans. Stockholders can attend annual corporate meetings and propose resolutions to be voted upon at those meetings, whereas partnerships generally do not hold annual or other meetings of partners. In recent years there have been various proposals to provide "investor democracy" rights to holders of limited partnership interests, but the proposed rights are considerably narrower than the rights of corporate stockholders and, in general, there is no precedent for the exercise of such proposed rights without the investors being deemed liable as general partners. One result of this prohibition against participation in the management of an enterprise is that publicly traded limited partnerships are much less likely than corporations to be the subject of third party tender offers at elevated prices or similar corporate activities which might permit an investor to realize increased returns as a result of overall conditions in the financial markets;

(iii) In deciding whether to invest in a publicly traded limited partnership or in a corporation, an investor must first analyze the agreement of limited partnership and the certificate of limited partnership by which the partnership was formed. These documents set out the basic structure of the partnership and the means by which it will operate, and must be signed by all partners. There are no corresponding documents for corporations, corporate charters and by-laws having become largely standardized;

(iv) Generally an investor may receive corporate stock in exchange for money or property provided to or services performed for a corporation, but an investor may not receive an interest in a limited partnership in exchange for services performed. Moreover an investor may not be able to acquire an interest in a limited partnership even if he wants to contribute money or property. Various statutes and rules limit the ability of certain investors to acquire partnership interests. For example, the regulations with respect to acquisition of oil and gas leases on federal lands provide, in essence, that aliens may not own interests in partnerships which acquire interests in such leases, but that, subject to certain regulations, many aliens can hold stock in corporations which acquire interests in such leases;

(v) Corporations can merge and undergo other reorganizations and activities pursuant to well established statutory provisions for which there are no corresponding provisions applicable to partnerships. If a corporation is acquired, merged, or otherwise reorganized there are often statutory dissenters rights available to stockholders which would not be available to limited partners of a partnership if that partnership were somehow acquired or reorganized. Therefore an investor in a publicly traded limited partnership has considerably less control over his investment, and considerably less likelihood of benefiting from corporate activities or transactions with third parties, than if he invested in corporate stock; and

(vi) An investor seeking to terminate his investment will also find that there are significant differences between an investment in a limited partnership and an investment in a corporation. First, there is a greater likelihood of his investment being terminated involuntarily if it is in a limited partnership, because corporations normally have perpetual existence while limited partnerships normally exist for particular time periods and, in any event, are dissolved upon the retirement, death, or insanity of a general partner unless the partnership is then reconstituted. For someone who wants to sell his investment in an ongoing entity, the only significant limitations on the sale of corporate stock are generally those imposed by federal and state securties laws. Transfers of limited partnership interests are bound by the same securities laws, and are also generally restricted by provisions whereby not all potential assignees could be admitted to a partnership as substituted limited partners, at least not without the consent and affirmative action of the general partner of the partnership. If, rather than selling his interest, an investor is to receive a distribution in liquidation from the entity in which he has invested, he will generally find that he shares equally with all other holders of stock of a similar class and series if he is a corporate stockholder, but if he holds a limited partnership interest he may have a priority as to distribution of assets on dissolution which is

> different from other limited partners, and in any event his priority relative to certain other investors is fixed by statute.

Even if the above-described differences between an investment in a publicly traded partnership and an investment in corporate stock were deemed to be insufficient to remove the Staff's perceived "similarity" taint, it is clear that all limited partnerships, publicly traded or not, share these characteristics. The only distinction between a publicly traded partnership and one that is not publicly traded is the degree of liquidity of the interests in the former. However, almost all limited partnership interests are liquid to some extent (often by means of required redemptions of interests by the general partner) and thus using any test of similarity, publicly traded partnerships are much more similar to non-publicly traded partnerships than they are to corporations. Accordingly, the Staff's neutrality analysis is incorrect -- either the Proposal should be broadened, following an in-depth study of the issue and an analysis of all of the collateral effects of the proposed solution, to treat all limited partnerships as corporations thereby achieving neutrality as between similar entities or the Proposal should be abandoned. We believe that the latter alternative is the only one of the two which is feasible.

The Administratibility Issue. The Staff also justifies the Proposal on the basis that "substantial questions" have been raised with respect to the administrative and audit problems allegedly present in a publicly traded limited partnership. Although McCormick has not yet acquired or installed a tax reporting system for its proposed successor partnership, based upon (i) our analyses of various computer systems and (ii) our discussions with the general partner representatives of existing publicly traded limited partnerships, it is our conclusion that we will be able to develop reporting systems that resolve all substantial administrative and audit problems. In fact, we agree with the conclusion of the Treasury that the sophisticated systems and computer hardware utilized by publicly traded limited partnerships are likely to result in considerably fewer administration and audit problems than are currently encountered with small non-publicly traded partnerships.

In addition, any perceived administration or audit problems can be effectively resolved by means of the partnership centralized audit procedures enacted as part of the

Tax Equity and Fiscal Responsibility Act of 1982. [2/] These provisions enable adjustments to items of partnership income, deduction or credit to be made at the entity level and then passed through to each partner.

The "Disincorporation" Issue. In addition to the adverse effect adoption of the Proposal would have on McCormick, it is respectfully submitted that, especially in the context of a corporation liquidating into a publicly traded partnership, the primary perceived justification for the Proposal is simply not applicable. As discussed above, the Preliminary Report concludes that it violates the tax neutrality principle not to tax publicly traded limited partnerships as corporations; implicit in this concern, as evidenced by the reference to the *Forbes* article, is the inference that the lack of tax neutrality will cause American corporations to rush into liquidation plans in order to disincorporate. However, this analysis ignores the substantial income tax costs incurred by both the liquidat-

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[2/] It should be noted that these provisions, contained in Sections 6221 through 6232 of the Internal Revenue Code of 1954 (the "Code") had not been enacted into law at the time the ALI Subchapter K Proposals were made.

ing corporation and its shareholders in converting to partnership form. To a substantial degree, these "toll charges" should be properly characterized as a prepayment of or a substitute for the corporate level tax thus eliminating any "neutrality" violation justification for the Proposal in a liquidating corporation context. Separate and apart from the very substantial non-tax differences between a limited partnership and a corporation that influence the selection of a business form, the magnitude of the tax toll charges that would be incurred in converting most corporations to publicly traded limited partnerships effectively preclude such conversions.

The tax costs of conversion ensure that restructurings of this type are limited to a relatively narrow range of existing corporations and thus it is highly unlikely that America will be "disincorporated" as postulated in the Forbes article. For example, the depreciation and investment tax credit recapture costs (discussed below) should preclude most mature, depreciable-asset intensive corporations from converting to the limited partnership form of business structure.

In general, there are two methods of liquidating a corporation into a partnership -- a complete liquidation and a partial liquidation -- and each method results in tax consequences at both the corporate and the shareholder level.

With respect to a complete liquidation, Section 336 of the Code provides in general that a corporation does not recognize any gain or loss as a result of the distribution of its property in kind to its shareholders in the course of a liquidation. There are, however, both statutory and judicial exceptions to that rule.

Generally, the statutory exceptions to the nonrecognition rule include such items as the recapture of depreciation and cost recovery deductions (Sections 1245 and 1250), the recapture of intangible drilling and development costs (Section 1254), the recapture of mining exploration expenditures (Section 617), the recapture of certain investment tax credits that had previously been claimed by the corporation (Section 47), and various similar types of recapture provisions. In effect, these provisions "prime" the nonrecognition rule and result in almost every liquidating corporation engaged in an active trade or business incurring some tax liability upon liquidation. Further, it should be noted that (i) in many instances, but for the liquidation the recapture tax burdens would never be incurred since the corporation would never "dispose" of the recapture-tainted assets, (ii) the liquidation results in the permanent loss of any net operating loss and investment tax credit carryforwards and (iii) in the context of an oil and gas corporation, a liquidation results in the loss of percentage depletion with respect to properties that are proven at the date of such liquidation.

In addition, there are judicial exceptions to the nonrecognition rule, the most notable of which are the so-called tax benefit rule and the assignment of income rule. The assignment of income rule prohibits a corporation from avoiding the tax on income which is economically accrued (but not recognized for income tax purposes) by distributing the right to that income to its shareholders in liquidation. See, e.g. Wood Harmon Corp. v. United States, 311 F.2d 901 (2d Cir. 1963) (liquidating corporation taxed on condemnation award right distributed to shareholders). The tax benefit rule requires the liquidating corporation to restore deductions claimed by it with respect to distributed assets which, in light of the continuing value of the assets to the shareholders following liquidation, have proven to be unwarranted. See, e.g. Hillsboro National Bank v. Commissioner, ___ U.S. __ (March 7, 1983) (83-1 U.S.T.C. ¶9229).

A corporation undergoing a partial liquidation also incurs substantial tax liability. For partial liquidation transactions occurring subsequent to the effective dates of the various Code provisions modified by the Tax Equity and Fiscal Responsibility Act of 1982, a corporate level tax is generally imposed on the distribution of appreciated property pursuant to such partial liquidation measured by the difference between the fair market value of a distributed asset and its adjusted tax basis. The exceptions to recognition treatment are not likely to be applicable to a publicly traded corporation. See, e.g. Section 311(d)(2)(B) (nonrecognition treatment at corporate level only if distribution made to noncorporate shareholder with respect to stock held for at least five years and representing 10 percent in value of outstanding stock of distributing corporation).

At the shareholder level, both complete and partial liquidations are in general taxed as though the shareholder is cashing out all or a portion of his investment in the corporation. Sections 331 and 302(b)(4). The shareholder thus recognizes gain on the difference between the fair market value of the assets distributed to him and his basis in the stock surrendered (or deemed surrendered) therefor. For example, upon receipt of partnership interests in a partnership formed to succeed to the business or assets of a liquidating corporation, a shareholder is required to pay a tax toll charge despite the facts that, (i) in an economic sense, such shareholder has not realized an immediate benefit (in fact, the value of the corporate assets will have been reduced by the tax liability incurred by it in connection with the liquidation), and (ii) in most cases the shareholder has received no cash with which to pay the tax liability imposed on his receipt of liquidating distributions.

It should also be noted that the repeal of the General Utilities rule proposed in the Preliminary Report will, if enacted, be a major deterrent to disincorporation. The tax cost of disincorporating would then even more clearly outweigh any advantages of converting to a partnership and will thus preclude any proliferation of disincorporations as predicted in the Forbes article.

In summary, the tax costs of liquidating a corporation (such as McCormick) into a publicly traded partnership are generally substantial at both the corporate and shareholder levels. These costs, which in general would not be incurred but for the liquidation, are properly viewed as a prepayment of or substitute for the corporate level income tax. Accordingly, there is no neutrality principle violation and thus no justification for the Proposal in the context of a corporation liquidating into a publicly traded partnership.

Conclusions

From the foregoing it is clear that the Proposal suffers from serious shortcomings which militate against its inclusion in any specific legislative proposal, at least in the near term. These shortcomings include (i) the lack of any real basis for the Proposal, i.e., contrary to the Staff's view, the tax objectives of neutrality (both in the context of publicly traded limited partnerships generally as well as in the context of publicly traded limited partnerships formed to succeed to the assets of a liquidating corporation) and administrability are not frustrated by present law as applied to publicly traded limited partnerships, nor are such objectives achieved through the Proposal; (ii) the apparent lack of any comprehensive study of either the experience of existing publicly traded limited partnerships or the Proposal and its collateral effects, which stands in marked contrast to the high degree of study and analysis applied to other issues addressed in the Preliminary Report; (iii) the disregard of the close relationship of the Proposal to other entity classification issues, which would seem to require that all such similar issues be addressed in a single coherent fashion rather than on a piecemeal basis; and (iv) the overstatement of the "disincorporation" problem.

Finally, it must be recognized that the adoption of the Proposal will result in the exclusion of a substantial class of investors not only from the oil and gas industry but from other areas such as real estate activities where capital formation has traditionally been effected through the partnership vehicle. For example, investors in oil and gas operations put their funds at risk only if the various tax deductions associated with such operations are passed through to the investor on a current basis. This pass through can only be accomplished effectively by an investment in a partnership, but the minimum purchase requirements for interests in most oil and gas partnerships exclude all but the affluent from making such investments. The publicly traded partnerships allow the small investor to participate in the oil and gas business. This investment vehicle thus provides a source of capital for the oil and gas industry at a time when a crucial need exists for exploration and development funds.

Respectfully submitted,
Sanford McCormick
Sanford E. McCormick
Chairman of the Board of
Directors and President
McCormick Oil & Gas Company

STATEMENT OF

ROBERT C. MURRAY
PRINCIPAL

MORGAN STANLEY & CO. INCORPORATED

to the

SENATE FINANCE COMMITTEE

on the

PRELIMINARY REPORT ON "REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS"

OCTOBER 28, 1983

Morgan Stanley & Co. Incorporated respectfully submits this statement and requests that it be included in the record in connection with the recent hearings on the Senate Finance Committee Staff's Preliminary Report on "Reform and Simplification of the Income Taxation of Corporations" (released September 22, 1983). In this letter we are commenting solely on several aspects of the preliminary report, which we believe would have a profound and disproportionate impact on utility companies, both electric and gas utilities. Our specific concerns are with the provisions affecting:

1. The one-year holding period for the "dividends received deduction".
2. The disallowance of interest deductions for corporations which invest in preferred and common stocks.
3. The repeal of the earnings and profits limitation (i.e., the return of capital limitation).

As a leading investment bank in utility financing, we are concerned about the effects of these provisions, if enacted, on the capital formation process for utility companies. The remainder of this letter will discuss our concerns with respect to these three provisions on this important sector of the U.S. economy.

1. One-Year Holding Period

    a. Preferred Stock. Preferred Stock, as one of the three major types of long-term securities sold by corporations, plays a vital role in financing industry. Utility companies rely on preferred stock for financing of their capital requirements more than any other industry in the private sector. Approximately $11 billion of preferred stock has been issued by utilities in the 1978-1982 period (over 60% of the total sold by all industries). A substantial portion of the preferred stock sold by utilities has historically been purchased by institutions. Even with the participation by institutions, the market for preferred stock has been limited as to size and availability. We believe that the imposition of a one year holding period would cause many institutional investors to cease to be buyers of preferred stock because liquidity is a very important feature to them. For those remaining institutions, the rate they would require on preferred stock would be substantially higher reflecting the loss of liquidity as well as the risk of taxability should changes in their corporate situation require disposition of these investments within a period of less than one year. As a result, we would expect the cost and size of preferred stock offerings to be adversely affected, thus limiting an important source of needed funds by utilities.

In a related area, an increase in the holding period would essentially eliminate the market for adjustable rate preferred stock. During 1983 to date, $510 million or about one-third of the preferred stock sold by utilities has been issued on an adjustable rate basis. This new security has opened up a significant new source of investment capital for preferred stock issuers. Most of this stock, however, has been purchased by institutions, which place particular value on liquidity. We believe that most of these institutions intend to hold these securities for longer than one year but they require the flexibility to sell them if economic conditions change. As a consequence, if faced with a "required" one-year holding period, these institutions would only be willing to buy these securities at much higher rates to offset the probability of future tax liability if conditions forced an early sale. The effect of these higher rates would be to eliminate what has until now been an attractive (in terms of cost) financing alternative for utilities.

b. Common Stock. The sale of common stock by utilities is likely to be less affected by a change in the holding period than preferred stock principally because a greater percentage of buyers of common are either individuals or tax-exempt buyers (e.g., pension funds, etc.). Taxable corporate buyers have, however, become important investors in utility common stocks in recent years and currently are estimated to represent at least 30% of recent utility trading activity. An increase in the holding period would result in a substantial reduction in the volume in trading of utility common stocks by such institutional investors*. In turn, this would reduce the liquidity of utility stocks which would adversely affect the cost of capital for these companies.

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* As an aside, we note that this effect of the proposed tax change would extend to the market for all common stocks, not just those of utilities, and could affect the liquidity of the market in general.

In addition to the foregoing, we fail to understand the rationale of matching the required holding period for the "dividends received deduction" with the holding period for capital gains. We also understand that consideration is being given to a reduction in the holding period for capital gains to six months, making a holding requirement for one year for the "dividend received deduction" somewhat inconsistent.

2. Disallowance of interest deductions by corporations investing in preferred stock.

   a. Preferred Stock. As with the proposal to lengthen the holding period for the "dividends received deduction", a disallowance of the interest deduction by corporations investing in preferred stock could have a major adverse impact on the market for utility preferred stocks. Corporations are major buyers of preferred stock. Few corporations actually borrow with the intention of engaging in a tax arbitrage but almost all have some debt outstanding. In trying to eliminate the abuses of a few, the proposed tax change would eliminate a large proportion of the potential buyers of utility preferred stocks or cause these corporate investors to require a significant increase in dividend rates to account for the added income tax liability.

b. Common Stock. The effects of an elimination of corporate interest deductions when common stock dividends are received would have an effect on the market for utility common stocks similar to that of the proposal to increase the holding period (see 1.b. above). Specifically, trading in common stock would be substantially reduced, adversely affecting liquidity and, in turn, increasing the cost of capital.

3. Repeal of the Earnings and Profits Limitation (i.e. Return of Capital Limitation)

As has been described by the Edison Electric Institute in its testimony before this Committee, the return of capital for utilities results primarily from the practice of capitalizing allowance for funds during construction. This practice has been mandated by rate regulatory authorities and should not be regarded as a tax abuse. Utilities with return of capital provisions on their common stocks are generally those utilities with larger construction programs and significant capital requirements. We estimate that approximately 90% of the shares of those utilities which had return on capital provisions in 1982 are owned by individuals, (not by institutions), to whom the return of capital provision is an important aspect of their return. If the return of capital provision were to be eliminated, we would expect these investors to require an increase in the yield on the common stock of these utilities. This would increase the cost of capital for these utilities, which, over time, would result in higher rates to consumers.

Summary.- In closing, we believe that the proposed provisions discussed above would have major negative effects on both investors and ratepayers of utilities. For investors, the provisions, if enacted, would result in sizable market losses in the dollar value of their outstanding preferred stock and to a lesser extent common stock. We note that these changes would adversely effect not only institutional holders of preferred and common stocks but also individuals, since the expected decrease in market value would reduce the value of securities in individual hands as well. We believe that retroactive tax changes of this kind are unfair to investors.

For ratepayers this would translate over time into higher electric rates since the provisions would increase the cost of financing by utilities. In addition, we believe that the proposed provision would make it more difficult for utilities to attract capital needed to finance construction programs for this important sector of the U.S. economy.

We thank the Committee for this opportunity to express our views on these proposals.

MORGAN STANLEY

MGIC Investment Corporation

Marshall E. Schwid
Executive Vice President-Investments

October 28, 1983

Mr. Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D. C. 20510

Attention: Proposals re Reform of Corporate Taxation

Dear Sir:

MGIC Investment Corporation wishes to submit the following comments for consideration relating to "The Reform and Simplification of the Income Taxation of Corporations," a report prepared by the staff of the United States Senate Committee on Finance. MGIC Investment Corporation is the parent of a number of insurance companies including Mortgage Guaranty Insurance Corporation.

The companies are regulated by various State Insurance Departments and taxed as ordinary corporations. We own sinking fund and perpetual preferred stocks (largely utilities), which, in our opinion, would suffer a significant decline in value should a proposal for the dividend exclusion extension be adopted. We also own common stocks and have written options on some of them to help hedge the market value of our holdings. These markets, common stocks and options, would also be harmed

MGIC Plaza, P.O. Box 488, Milwaukee, Wisconsin 53201, (414) 347-6417

by lengthening the holding period. The following points, we believe, should be noted when considering the implication of the proposed longer holding period for dividend exclusion eligibility.

1) Liquidity in the preferred market is already limited. These proposals could reduce the existing liquidity, making preferreds much less attractive to investors, causing issuing companies to pay much higher rates.

2) We have never purchased a preferred stock with the intention of selling on a short-term basis. But if preferred dividends were fully taxed for a short holding period, it would make them much less attractive to us since we require (and insurance regulators encourage) our investments to have ample liquidity. We require liquidity in investments of policyholder reserves and for portfolio management reasons. To maintain liquidity and reduce short-term market risks we would either avoid investing in preferreds or require higher returns from these equities to compensate for lessened marketability.

3) The proposed extension of the holding period for dividend exclusion by corporations would drastically harm our present holdings. The market value of our preferred holdings, approximately $210 million, would decline by 15-20% in the opinion of acknowledged specialists; this would result in

a $31 to $42 million reduction in value. Eventually this decline will result in lower tax revenues when these securities are sold at depressed prices.

4) Various State Insurance Departments have approved the use of options on common stocks as hedging devices after study of the advantages to insurance company portfolio management. Since all options have maturities under nine months, an extension of the dividend exclusion on the underlying securities would reduce the attractiveness of options hedging. Optionable stocks would be penalized and portfolios would have less flexibility with little additional tax revenue generated.

5) As indicated above, we believe insurance companies would be seriously affected by the proposal. According to statistics derived from A. M. Best's Market Guide, Property/Casualty insurers own $9.2 billion of preferreds of all types (market value) and the Life/Health group, $13.3 billion (statement value) as of December 31, 1981. These preferreds would be exposed to a 15-20% loss in value, or more than $3 billion.

6) With a less attractive preferred market and the higher yields demanded by investors caused by exclusion period changes, more issuers, in our opinion, would be forced to offer debt in lieu of preferreds. Interest on debt is tax deductible whereas dividends are not. Under the

proposed changes the financial markets would penalize issuing corporations for higher debt vs. equity ratios and at the same time outstanding preferreds would be penalized in the marketplace.

7) These effects on the markets are contrary to the goals of the Office of the Comptroller of the Currency which has pushed for more equity type financing of banks and the Energy Department which through "dividend reinvestment program" deductions has intended to help the electric utility industry. This industry has been actively issuing new preferreds and commons to provide an equity base for expanded capacity.

8) The proposal that a holder who gets the dividend exclusion may not also take an interest expense deduction is unjustified. There are sound business and economic reasons for incurring debt while holding preferreds or commons either on a permanent basis or temporarily until the funds can be redeployed. The basic economic criterion that the expected total return (payments and change in value) exceeds interest expense, on a pretax basis, justifies many types of transactions.

9) To date approximately $6.7 billion of adjustable rate preferreds have been issued. Of these, 66% were issued by banks, 11% by insurance companies, and 23% by utilities

and industrial companies to raise capital at the lowest cost. Coupon payments are fixed to certain indexes so the issuer and the buyer are paying and receiving a rate related to the indexes and neither is tied to a permanent rate. Corporate holders of this type of preferred hold equities they may not be able or willing to own indefinitely and should not be penalized if they elect to sell within a one year holding period

10) Regarding arrearages, the case of Chrysler's preferred has had much publicity and may have been abused. We would point out that situations like this are extremely rare. If the main thrust of the proposal is to stop abuse we see little need to change the present regulation of all preferreds. The corporate exclusion for the holding period of dividend arrearages, presently covered by IR Code 245(c)(2), is 90 days. This could be changed to a longer period or perhaps some formula could be devised whereby the holder only receives an exclusion on the portion of the dividend period for which he holds the stock.

11) The arguments in favor of the proposals as stated on page 105 appear very superficial. The proposition that current dividend rules encourage takeover attempts assumes that takeovers or attempted takeovers are bad, per se, and that the dividend on the common stock of the target company is a critical element in attempting a takeover. It is possible

that takeover attempts can be beneficial to an efficient economy, keep corporate management alert, and provide a mechanism for removing bad management. When the value of a takeover target is being analyzed, its assets, earning power, organization, and market share would appear to be far more significant factors than the exclusion benefits accruing to dividends during the takeover period.

Another argument presented is that the present period of the exclusion has skewed the interest of corporate investors toward stocks and away from debt. In response, these two types of securities have very different market and financial risks and thus are not comparable on a taxability basis alone, and second, the largest buyers of both debt and stocks are tax exempt institutions (pensions, savings plans, mutual funds, foundations, and endowment funds).

Finally, it is said that the rules presently permit a non-taxpaying corporation to issue a preferred in lieu of debt, giving the preferred buyer the benefit of the exclusion. This implies that a corporation in such bad straits that it pays no taxes is going to find another corporation willing to purchase its equity instead of its debt. Further, if the issuer plans to remain in business, how long can it avoid paying taxes, at which time the dividend payments are not deductible?

In conclusion, we are concerned that should this proposal lead to legislation it would be a step in the direction of triple taxation and might reduce Treasury revenue rather than increase it.

Very truly yours,

Marshall E. Schwid
Executive Vice President-Investments
MGIC Investment Corporation

MES/cm

cc: Mr. Carl F. Arnold
The Honorable Robert J. Dole

MUDGE ROSE GUTHRIE ALEXANDER & FERDON
20 BROAD STREET
NEW YORK, N.Y. 10005-2680
212-701-1000

NATHAN ABRAMOWITZ
JOHN H. ALEXANDER
JOHN L. ALTIERI, JR.
GEORGE F. ANDEREGG, JR.
BLISS ANSNES
THOMAS BARR IV
JOHN G. BOVE
WALTER E. BREEN
WILLIAM H. CANNON
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NICHOLAS J. CAPOZZOLI, JR.
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ROBERT J. GILLISPIE
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JAMES P. MARLIN
GEORGE J. MARTIN, JR.
ARTHUR F. McMAHON, JR.
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LAURENCE V. SENN, JR.
HARRY G. SILLECK, JR.
OTTO G. STOLZ
(D.C. ONLY)
ARNOLD H. TRACY
DAVID A. VAUGHAN
WILLIAM N. WALKER
DONALD J. ZOELLER

RANDOLPH H. GUTHRIE
MILTON C. ROSE
HENRY ROOT STERN, JR.
H. RIDGELY BULLOCK
COUNSEL

CABLE ADDRESS
BALTUCHINS-NEW YORK

TELEX 127889

TELECOPIER
212-701-1667
212-425-4109
212-701-1698/99

2121 K STREET, N.W.
WASHINGTON, D.C. 20037
202-429-9355

12, RUE DE LA PAIX
75002, PARIS, FRANCE
261-57-71

SUITE [illegible]
333 SOUTH GRAND AVENUE
LOS ANGELES, CALIF. 90071
213-613-1112

October 27, 1983

Roderick A. DeArment, Esq.
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. DeArment:

Please consider this letter as my written statement for submission and inclusion in the printed record of the hearing held on Monday, October 24, 1983 on the Reform and Simplification of the Corporate Income Tax.

I am troubled by the Staff's proposal to impose a "full corporate level tax" on all gain realized on the sale of assets by a corporation pursuant to a liquidation that is governed by Section 337 of present law, or on the complete liquidation of a corporation that is presently governed by Section 336.

For many years, corporations have been able to sell their assets and liquidate with only one tax imposed (other than certain recapture items), the tax on the shareholders. Similarly, if a corporation liquidates first, and then the shareholders sell its assets, Section 336 provides no corporate tax on the liquidation (again, other than recapture), and again there is only one imposition of tax, on the shareholders upon the liquidation. The third means of accomplishing this result, by selling the stock itself, also involves only one tax, that imposed on the shareholders, irrespective of whether the purchaser stepped up the basis in the assets by liquidating under Section 334(b)(2) (pre-TEFRA) or made a Section 338 election (post-TEFRA). Corporations have been bought, sold, valued and bequeathed based on this form of taxation, which has been carefully thought through, and has always seemed to me to function well. In effect, this single taxation system on the complete liquidation of a corporation is a form of integration of the corporate and individual tax systems. The Staff Committee Report fails to provide a compelling reason for a change in the law, and proposes a two-level tax system on the complete sale of corporate assets that in my view results in double taxation that is objectionable from a tax policy standpoint. Such a proposed approach is a retreat from corporate-shareholder integration, and I believe should be considered only if some other form of integration is included as a substitute.

One reason given by the Staff for their proposal to tax all corporate gain is a desire for "simplicity." The Staff proposals hardly seem to me to constitute simplification. It is stated that one substantial simplification would be that Section 341, dealing with collapsible corporations, could be repealed for domestic corporations if all corporate level gain were subject to tax. I question this assertion. It seems to me that even under the Staff proposals, repeal of Section 341 would open unintended loopholes in the Internal Revenue Code.

Section 341 is intended to have the effect of converting long-term capital gain realized by the seller of corporate stock into ordinary income if the corporation is "collapsible." Through the use of statutory rules in Section 341(e), in certain instances the business activities of a substantial shareholder are attributed to the corporation for purposes of determining collapsibility. Thus in the case of the real estate dealer who holds real estate in a corporation, the individual's dealer-activities are taken into account and the corporation therefore may become collapsible, with the result that a sale by the individual of its stock would produce ordinary income.

For some reason, it is assumed that, because under the Staff proposal all assets in corporate solution cannot leave that solution without tax, Section 341 is no longer necessary. I believe this is an incorrect assumption. Without Section 341, an individual in the business of selling unimproved real estate, or cars, or antiques, or yachts, or an artist selling his art, to cite only a few examples, would have a substantial incentive to incorporate each asset that he is holding for sale. He could then hold the stock for the required period to obtain long-term capital gain and only pay a 20 percent tax on what should be ordinary income. In many of these cases, there would be no advantage to the purchaser in obtaining a step-up in basis of the asset at the corporate level, so no corporate tax would ever be paid. In other cases, the corporate tax would be deferred for a long period of time, so that the present value of the corporate tax would be much less significant than the reduction in the seller's tax from ordinary rates to capital gain. The car would depreciate in value, the art would be hung on a wall and ultimately be transferred by the subsequent sale of stock, and the real estate may be leased rather than sold, or sold many years later. The net result would be that the individual dealer would have a much easier time of converting what should be ordinary income from the sale of goods maintained as his stock in trade into capital gain.* With Section 341 in the Code, such positions probably could not properly be taken on a tax return. Without Section 341, taxpayers would be more willing to run the risk.

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* Of course, the IRS could argue that the stock itself is an asset held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. This is a more difficult position for an auditing agent to maintain, and Schedule D reporting of many ordinary income type transactions would never be challenged.

It seems to me that Section 341 will have to be retained in some form. Indeed, the Staff might well spend some time "revisiting the old misfortune" of Section 341 to fix it up so that it functions properly. Perhaps Section 341(f) needs reconsideration, for some of the abuses described above could occur under current law if a Section 341(f) election is made. Section 341 is one provision of Subchapter C that does need revision -- but repeal would be a giveaway that our Treasury cannot afford.

In any case, I find the simplicity argument in favor of repealing General Utilities to be unpersuasive.

It is clear from the adverse reaction of the various Bar groups and others to the proposal of complete corporate taxation of gain on the sale or distribution of any corporate assets under any circumstances that some ameliorative provision will be necessary or the proposal will simply not have any chance of passage. My principal recommendation is to leave Sections 336 and 337 alone, and to repeal the other forms of General Utilities, i.e., those not involving the complete liquidation of a corporation. I would caution that if you repeal Sections 336 and 337 and if some ameliorative provision is deemed necessary, however, that a not unduly complex mechanism be selected. It seems to me that the A.L.I. shareholder credit approach is too complex, and would not benefit all shareholders (such as tax-exempt shareholders or shareholders purchasing the stock recently prior to the corporate transaction at a high basis so that the gain is realized by the selling shareholder who will not be eligible for the credit).

One possibility, if Sections 336 and 337 must be modified, would be to impose the corporate level tax only on inventory (in other words, a rule similar to the LIFO inventory rule presently in Sections 337(f) and 336(b)). There might be some tax policy justification for this position, as finished goods inventory would otherwise be sold in the ordinary course, resulting in ordinary income, whereas its transfer to one purchaser in a Section 337 transaction generally results in no corporate level tax (other than on LIFO inventory) and in capital gain treatment for much of the appreciation in the inventory in the form of a tax on the shareholders. Of course, a rule would have to be worked out for the treatment of work in progress, which would be difficult.

This approach would leave free of double taxation the capital assets and Section 1231 assets of the corporation, such as property, plant, equipment, goodwill and other intangibles, while permitting the purchaser to obtain a cost basis for these assets.[*] I personally feel that double taxation of such items is inappropriate, and that cost basis treatment for the buyer is appropriate. Unless a major effort is undertaken to achieve corporate-shareholder tax integration, I do not believe this fundamental pattern of taxation should be changed.

I also question whether such double taxation would raise revenue. I rather doubt it, as I would expect that many taxpayers would not be willing to incur double taxation on such items and would choose other forms of transactions, or would simply not consummate such transactions. There is an example of such a situation in my law firm which is in the midst of a complete liquidation of a family holding company that will involve very large capital gain taxes on the shareholders. If there were also a tax on the corporation on the appreciation in the value of the assets, the resulting additional tax would be approximately the same as the tax on the shareholders, and there would be no liquidation and no revenue collected by the Government.

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[*] Under the Staff proposal goodwill may be treated as carryover basis property even if a cost basis election is made, Staff Report at 58, and in effect a corporation can elect which assets are to be given cost or carryover treatment by incorporating the assets in separate transactions in advance of the sale, see Staff Report at 57.

Thank you for the opportunity to comment.

Very truly yours,

J. Roger Mentz

JRM:lp

cc: John E. Chapoton
Assistant Secretary for Tax Policy
Department of the Treasury

Ronald A. Pearlman
Deputy Assistant Secretary for Tax Policy
Department of the Treasury

Robert G. Woodward
Tax Legislative Counsel
Department of the Treasury

David H. Brockway
Chief of Staff
Joint Committee on Taxation

Richard S. Belas
Deputy Chief Counsel
Senate Committee on Finance

André LeDuc
Tax Counsel
Senate Committee on Finance

David Hardee
Minority Tax Counsel
Senate Committee on Finance

Ken Kies
Minority Tax Counsel
House Ways and Means Committee

John J. Salmon
Chief Counsel
House Ways and Means Committee

National Association of Independent Insurers

STATEMENT OF THE
NATIONAL ASSOCIATION OF INDEPENDENT INSURERS
FOR SUBMISSION TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

STATEMENT OF THE
NATIONAL ASSOCIATION OF INDEPENDENT INSURERS
BEFORE THE
UNITED STATES SENATE FINANCE COMMITTEE

The National Association of Independent Insurers (NAII) is a property and casualty insurance trade association representing more than 500 companies. Our membership includes all forms of corporate organization (stock, mutual, Lloyds and reciprocal) and includes companies operating on a countrywide basis as well as those operating within a single state.

We understand that the Senate Finance Committee is currently considering changes to the 85% dividend received deduction provision of the Internal Revenue Code, and a disallowance of 85% of the interest deduction for borrowed funds where the borrowing taxpayer has purchased common or preferred stock.

Our member companies support the Committee's efforts to uncover abuses of the Internal Revenue Code, and its efforts to deal with specific abuses. However, we submit that the changes being considered are so fundamental that further study is required to be certain that abuses are identified, and that the language that is developed will specifically deal with such abuses.

Property/casualty insurance companies currently own some $10 billion of preferred stock and an additional $50 billion of common stock. Our industry has a direct and significant interest in any action that affects the market value of its investment portfolio. We reasonably expect significant changes in the market value of preferred and common stocks as a direct result of changing the holding period. Most preferred stocks would be materially and adversely affected. They would no longer sell at rates equal to, or better than comparable debt issues. Loss estimates have run from 10% to 18%

of current market value, depending upon the characteristics of the specific issue. Significant changes in the market value of our stock portfolios place an undue burden on insurance companies' solvency and their ability to meet their financial obligations to the public.

Corporations usually incur debt in the ordinary course of doing business. To relate such debt to the purchase of stock for the purpose of determining an interest deduction will obviously lead to serious financial strains that will be followed by protracted arguments with the Internal Revenue Service, and quite likely time consuming and costly court actions.

NAII firmly believes that additional study is needed to specifically identify and treat only abuses and to carefully develop specific language to deal with such abuses. We submit that a major change without further study is unwarranted, and will be harmful.

NATIONAL INVESTMENT SERVICES
OF AMERICA, INC.

October 26, 1983

Mr. Roderick A. De Arment
Chief Counsel, Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Re: U.S. Senate Finance Committee Hearing on
Taxation - "Reform & Simplification" Report,
October 24, 1983

Dear Sirs:

On several points:

a.) 85% dividend exclusion,

b.) Deductibility of interest paid to purchase or carry stock,

c.) Lengthening the period held to be reviewed in your hearing;

you seem to be overlooking one very basic point. Dividends are paid with after-tax (or non-deductible) dollars. That point alone negates any consideration you might have about limiting exclusion, lengthening holding, or questioning interest deduction. The consideration should be how to correct the "double" taxation of the 15% not excluded, or taxes paid on dividends received beyond a changing limit for individuals.

Gentlemen, in your effort to address the revenue shortfall, you are too easily swayed to the easier increase revenue or taxes route versus controlling outflows by reducing and restricting expenses.

You would be doing equity markets, in particular preferred markets, a great disservice. Please consider your actions carefully and remember the basic point. Dividends are paid with after-tax or non-deductible dollars.

Yours very truly,

Thomas R. Tuschen
Vice President and
Portfolio Manager

TRT/lcb

SUITE 1501 / 815 E. MASON STREET / P.O. BOX 2143 / MILWAUKEE, WISCONSIN 53201 / (414) 271-6540

ROBINSON, SILVERMAN, PEARCE, ARONSOHN & BERMAN
230 PARK AVENUE · NEW YORK, N. Y. 10169
(212) 687-0400

ALAN J. B. ARONSOHN, P.C.
STANLEY BERMAN
STEVEN D. BLOOM
EDWARD S. COWEN
WALTER M. CURCHACK
FLORAN L. FINK
BARTLEY F. FISHER
JAMES F. GILL
CHARLES M. KOTICK
MICHAEL B. LEVY
EDWARD LOWENTHAL
HAROLD A. LUBELL
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SAUL PEARCE
MICHAEL N. ROSEN
BARRY C. ROSS
EDWARD B. SCHOEN
MATTHEW SILVERMAN
LAURENCE A. SPELMAN
GEORGE B. YANKWITT

VINCENT ALFIERI
ANDREW I. BRONFMAN
STEPHEN M. CHARME
JAY M. DORMAN
MAXINE FASS
ERICA R. FORMAN
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DOUGLAS HELLER
JOHN D. HIRSCHFELD
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KENNETH STUART HORN
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DEBRA M. KENYON
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BRIAN B. SMITH
JACQUELINE F. STEIN
MARK JON SUGARMAN
ANN TYSON
TODD J. WIESENECK
ROBERT A. WOLF
MICHAEL R. ZIENTS*

*ADMITTED CONN. BAR ONLY

BENJAMIN M. ROBINSON
([illegible])

CABLE: "ROSILPE"

TELEX: 237392 RSPAB UR

JOHN H. BALL
OF COUNSEL

November 8, 1983

Roderick DeArment, Chief Counsel
Committee on Finance, Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Sir:

This statement on the Finance Committee staff's preliminary report on "Reform and Simplification of the Income Taxation of Corporations" is submitted on behalf of the National Realty Committee. The National Realty Committee is a nonprofit business league whose membership includes owners, operators and developers of all types of real estate throughout the United States.

The National Realty Comittee recognizes that the Internal Revenue Code provisions governing the taxation of corporate transactions involve undue complexity and inconsistency. It commends the staff efforts to simplify and reform these provisions. The Committee shares the staff view that major changes to Subchapter C are required. The prelminary report released on September 22, 1983 provides a set of rules which in general, would substantially improve Subchapter C. While the Committee believes that fundamental revisions to Subchapter C along the lines of the staff proposals should be enacted by the Congress, it urges that such legislation be adopted only after broad and careful study by tax professionals and administrators, economists and business and industry groups. Substantial changes in basic structures require caution; haste is unnecessary and may prove dangerous.

A fundamental issue which should be resolved prior to enacting major changes in corporate taxation is whether the U.S. income tax system should maintain its two-tier structure, imposing separate taxes on income when it is realized by corporations and again when it is distributed to shareholders, or whether it would be better to eliminate or reduce the impact of the two-tier structure by adopting some form of integration of the corporate and individual income taxes. If long-run consistency and certainty are to be achieved in the revision of Subchapter C, the Congress should first answer this fundamental tax policy question.

Although the National Realty Committee generally supports revision of Subchapter C, provided sufficient time is allowed for evaluation, the Committee questions the advisability of some of the proposed rules on which Chairman Dole requested specific comments. In particular, the National Realty Committee has reservations about the proposal to overrule General Utilities and Operating Co. v. Helvering, 296 U.S. 200 (1935) and to repeal the non-recognition rules of sections 311, 333, 336 and 337 of the Internal Revenue Code.

The General Utilities decision and the related statutory non-recognition rules conflict with the principles that all corporate income should be taxable to the corporation and that a corporation distributing property should recognize gain or loss when shareholders receive such property with a cost basis. Nevertheless, requiring recognition of gain (or loss) at the corporate level whenever a corporation makes a distribution of appreciated property to its shareholders, even in liquidating distributions, would constitute a fundamental change in the tax law. Such a change would upset many taxpayers' justifiable reliance on long-settled tax treatment. It would impose an economic hardship on many corporations and their shareholders. Such a significant reversal of longstanding tax policy should be undertaken only after all its potential effects have been identified, evaluated, and, if burdensome, relieved.

Requiring corporations to pay tax on appreciation in distributed property will subject such property to taxation at two levels, the corporation and the shareholder, with respect to a single transaction. The corporation will pay tax on the gain at a maximum rate of 46% if short-term, or 28%, if long-term. The shareholder will pay tax on the entire amount of the distribution at rates up to 50%, if the distribution is considered a dividend. If the distribution is treated as a return of capital, the shareholder will pay tax on the difference between his basis and the amount received at a maximum rate of 50% if his gain is short-term, or 20%, if long-term. If both the corporation and the shareholder pay tax on a distribution at the maximum rates, the effective tax rate applied to the gain will be 73%. Even if both corporation and taxpayer pay tax at the lowest long-term capital gain rates, the combined effective rate will be 42.4%.

Repeal of General Utilities and related statutory nonrecognition rules will extend the present burdens of the two-tier corporate-shareholder tax structure to all corporate liquidations and redemptions. The economic problems caused by the failure to integrate our individual and corporate income taxes are likely to be aggravated, unless a repeal of the General Utilities decision is accompanied by some form of relief provision to alleviate this double tax burden.

Furthermore, repeal of the nonrecognition rules of General Utilities and Code sections 311, 333, 336 and 337, without any accompanying measures to alleviate the impact of such a change, may discourage taxpayers from adopting otherwise appropriate uses of the regular corporate form. Many small taxpayers will be induced to forego the nontax benefits and protections of incorporation in order to escape taxation of the same income at two levels. As a result, any increased simplicity and certainty achieved by the Subchapter C revision will risk being effectively undone to the extent that taxpayers opt for a single level of partnership taxation in spite of Subchapter K's complexities and uncertainties.

If the Congress decides to repeal the nonrecognition rules of General Utilities and the corresponding statutory provisions, the National Realty Committee urges that the

Congress simultaneously enact relief measures to prevent or reduce potential adverse effects of the change. A shareholder credit for taxes paid on appreciation by a distributing corporation would greatly reduce the immediate adverse impact of the proposed rules in many situations. However, other approaches to relief have merit and may better alleviate special problems. Thus, while the Committee recommends the credit approach, it also urges the Congress to study and adopt such additional relief measures as it considers necessary. The following relief measures have been suggested:

1. Shareholder Credit. Limited integration of corporate and individual income taxes could be provided by allowing shareholders, receiving in-kind distributions with a cost basis, a credit against their liability for some (or all) of the taxes paid by the corporation with respect to the distribution transaction. The American Law Institute's proposals for revising Subchapter C include such a credit.

2. Stock Basis Election. Tax at the shareholder level could be deferred by shareholders electing to substitute their stock basis for the basis of assets received. This approach, adopted by the staff report, eliminates the second tier of taxation while preventing the tax-free acquisition of a stepped-up basis. A stepped-up (or "cost") basis would be allowed only if the gain on the assets is recognized at both the corporate and shareholder levels.

3. Tax Deferral for Business Assets. If business assets are distributed by a corporation to shareholders who use the assets in an active business, part or all of the taxes due from the corporation and the shareholders with respect to the assets could be deferred until the ultimate disposition of the assets by the shareholders. Relief in these circumstances would avoid hampering business transfers and operations, and prevent tax considerations from "locking-in" assets. If this approach is taken, however, the legislation should make clear that real property rental constitutes an active business for purposes of this provision.

4. Historic Assets. As transitional relief for a corporation with appreciated assets held for a long period, the corporate tax on assets held in excess of a set number of

years could be completely forgiven, or reduced according to a schedule corresponding to the corporation's holding period for the asset. This type of relief might be appropriate for corporations holding assets for long periods prior to the repeal of the nonrecognition rules. In the absence of indexing, this rule would alleviate the tax on appreciation which merely reflects inflation, whether applied to assets acquired by a corporation before or after any repeal legislation.

5. Transitional Corporate Tax Phase-in. To the extent that imposition of a corporate level tax on appreciation in distributed assets is viewed as a transitional fairness problem affecting assets held prior to repeal legislation, any unfairness can be reduced or removed, as suggested in the staff report, by phasing-in the corporate tax.

In addition to its concern over the proposal to overrule the General Utilities decision, the National Realty Committee also has reservations concerning the proposal to repeal the earnings and profits limitation on the characterization of corporate distributions as dividends.

Assume, for example, that A contributes $100 to the capital of Corporation X, which utilizes the $100 to purchase a 10-year leasehold interest in real property. Assume further that Corporation X receives $20 net rental income from subtenants after the payment of all expenses but before the deduction of any amortization of its cost of acquiring its 10-year leasehold. If the corporation distributes all of its cash flow to A each year, after the payment of corporate tax, treating the entire cash distribution to A as a dividend, despite the fact that $10 a year represents economically simply a return of capital, appears unfair.

We note that the staff states that the adverse consequences of such dividend treatment can in most cases similar to the above example be avoided. The staff's preliminary report suggests that there would be no need to utilize a corporation in the first instance, that any such corporation could be liquidated or in the alternative that Subchapter S status could be elected.

Unfortunately, there are situations in which noncorporate ownership of property exposes the owners to substantial risks of liability, which they would prefer to avoid by incorporating. In addition, despite the recent liberalization of the Subchapter S rules, Subchapter S treatment is not always available. For example, one non-qualifying shareholder can eliminate the availability of Subchapter S benefits.

In summation therefore the National Realty Committee supports a continuing dialogue to seek solutions to the remaining problems inherent in the proposed Subchapter C changes.

Respectfully submitted,

Alan J. B. Aronsohn

WRITTEN TESTIMONY

Re: Opposition to Senate Finance Committee Staff's Proposal to Treat Publicly Traded Partnerships as Corporations

Submitted by: HART H. SPIEGEL
BROBECK, PHLEGER & HARRISON
One Market Plaza
Spear Street Tower
San Francisco, California 94105
Telephone: 415/442-0900

On behalf of: Newhall Investment Properties
and Newhall Resources

Senate Finance Committee Hearing
October 24, 1983

It has long been the law that partnerships are distinguishable from associations taxable as corporations for tax purposes on the basis of four corporate characteristics, namely, continuity of life, limited liability, free transferability of interests and centralization of management. A business entity possessing more than two of these characteristics is treated as a corporation. An entity possessing two or less such characteristics is treated as a partnership. Under current Treasury regulations, virtually any entity organized under the Uniform Limited Partnership Act or the Revised Uniform Limited Partnership Act is treated as a partnership.

The Staff of the Senate Finance Committee has propoproposed that all limited partnerships having publicly traded interests be henceforth treated as associations taxable as corporations. We oppose this proposed legislation for the reasons discussed below.

THE STAFF'S PROPOSAL IS NOT "NEUTRAL"; ALL PARTNERSHIPS SHOULD BE TREATED AS SUCH

If one accepts the fact that there are certain entities which should be taxed as partnerships under the Internal Revenue Code--and the repeal of Subchapter K is not being considered--then why should publicly traded entities be precluded from partnership treatment? Stated another way, why should the quid pro quo for tradeability of interests be taxation as a corporation?

We submit that there is no reason. The Staff also had a difficult time finding one. In their report, the Staff stated:

> "The principal argument against permitting publicly traded limited partnerships to be taxed as pass-through entities is one of neutrality: publicly traded limited partnerships are simply too similar to business entities that are taxed as corporations. The principle of taxing like organizations alike requires that publicly traded limited partnerships should be treated like corporations."

We can only ask: How "neutral" is a tax system which treats publicly traded partnerships differently from other partnerships? Limited partnerships, including publicly traded limited partnerships, are clearly distinguishable entities from corporations in the following respects, among others:

1. Limited partnerships are organized under state limited partnership acts. These acts differ substantially in substance from state laws under which corporations are organized.
2. A corporation's shareholders enjoy "automatic" insulation from personal liability for the entity's debts. On the other hand, limited partners of a limited partnership are insulated from personal liability only if, among other things, they participate to a very limited extent in the management of the partnership and if changes in the members of the partnership are reflected by regular filings in the states in which the partnership does business.
3. No shareholder of a corporation is subject to personal liability for debts of the entity. In contrast, at least one member of a limited partnership must serve as a general partner and have personal liability for the debts of the entity. Such personal liability may, if all goes well, not be visited upon the general partner. However, businesses do go bankrupt, and general partners have been known to bear the brunt of personal liability.

4. A corporation has an unlimited life, whereas a partnership's existence is subject to termination upon the occurrence of events specified by applicable state law and the partnership agreement.

A partnership is still a partnership whether its interests are publicly traded or not. A truly neutral tax system should treat all partnerships alike and should not make distinctions which are inconsistent with business reality.

THE ALI PROPOSAL RELIED UPON BY THE STAFF IS OUTDATED AND HAS BEEN REJECTED BY THE ABA

As the only independent support for its proposal, the Staff has cited the American Law Institute's 1981 proposal that publicly traded partnerships be taxed as corporations. The ALI proposal should be discounted for several reasons.

First, the proposal represented fear of the unknown. There were no publicly traded partnerships at the time the proposal was made. Indeed, the ALI Reporters noted a March 5, 1981, story in the New York Times relating the approval for listing of the units of Apache Petroleum Company, the first publicly traded partnership. The Reporters admitted they were operating in a vacuum:

> "The development is recent and the Reporters have had insufficient time to study its impact. Experience with Apache may provide further guidance as to the effect of allowing partnership treatment to such publicly-traded entities."

The Reporters' primary concern was that the Internal Revenue Service could not feasibly audit the partners of a publicly traded partnership. However, after the proposal was drafted, the Internal Revenue Code was amended to provide for audits at the partnership level. Since the Internal Revenue Service need no longer conduct audits on a partner-by-partner basis, the ALI proposal has lost its rationale.

In this regard, we also note that the existing publicly traded limited partnerships have developed sophisticated computer programs to account for transactions in a more precise manner than most other partnerships. These detailed record-keeping systems should make publicly traded partnerships relatively easy to audit. For example, the computer software of Newhall Investment Properties and Newhall Resources is designed to handle the mechanics of a Section 754 election and to track and report precisely the tax attributes of each partner's investment, including his allocable share of partnership income, his tax basis and his capital gain and recapture income upon disposition of his partnership interest.

The ALI proposal is logically inconsistent in singling out publicly traded partnerships for corporate treatment. Publicly registered partnerships with as many or more partners than publicly traded partnerships would continue to be treated as partnerships for tax purposes. There is no reason for such a distinction. Furthermore, any supposed tax administrative difficulties associated with publicly traded partnerships are no greater than such difficulties associated with other publicly traded "tax pass-through" entities, such as real estate investment trusts and mutual funds.

Significantly, the ALI proposal was rejected by the Tax Section of the American Bar Association at its Annual Meeting this past summer in Atlanta--despite the fact that the Tax Section generally approved various other changes to partnership taxation proposed by the ALI, including, as a general rule, unrestricted access to partnership treatment. This adverse reception by the country's tax practitioners clearly evidences the proposal's lack of a valid theoretical basis.

PUBLICLY TRADED PARTNERSHIPS REPRESENT A POSITIVE FINANCING ALTERNATIVE TO THE CORPORATE FORM, NOT A TAX "ABUSIVE" FORMAT

The Staff's report speaks of the publicly traded partnership as an "abusive" format. This label is unwarranted, as an examination of the current publicly traded partnerships reveals.

Some of these partnerships have been formed as a result of complete or partial liquidations of corporations faced with a market which accords a disappointingly low value to assets "locked up" in corporate form. For various nontax-related reasons, the same market attributes a significantly higher value to assets in partnership form, and the formation of these publicly traded partnerships benefited the entities and their shareholders by increasing equity values and, in some cases, setting the stage for liquidation of assets or further financing.

Other publicly traded partnerships have been formed through the combination of numerous untraded partnerships--so-called "roll-up" transactions. There is obviously no tax abuse involved in a roll-up, since the partnership form is maintained before and after the transaction. These transactions have provided liquidity to partners who could not otherwise readily dispose of their partnership interests.

It should also be noted that the currently existing publicly traded partnerships either produce taxable income or relatively minor tax benefits to their investors. Thus, we are not dealing with entities generating substantial "tax shelter" for their participants. In fact, the formation of partnerships through corporate liquidations has increased the government's revenue due to substantial corporate and shareholder taxes paid in the transactions.

Any talk of "abuse" would be better addressed to those many lower visibility, untraded partnerships throwing off tax benefits greatly in excess of current cash investment. Ronald Pearlman, Deputy Assistant Secretary of the Treasury, in testifying in opposition to the Staff's proposal, agreed with this assessement:

> "[W]e suspect that the reporting requirements imposed upon publicly traded and registered partnerships and the public scrutiny that these organizations receive make them less likely to engage in abusive activities than partnerships with fewer partners."

CONCLUDING COMMENTS

In the past the partnership was utilized almost solely for small business ventures, and the law governing partnerships was not well developed. We are now at a different point in history. A separate body of law and a separate type of entity which is, in certain instances, a viable alternative to the corporate form has evolved in this country. The proposed legislation would fly in the face of this trend and would put severe limits on the use of the partnership as a business vehicle by precluding the use of a partnership for the purpose of obtaining financing from those understandably concerned with having freely transferable interests.

Tradeability of interests has never been viewed as the preeminent factor for distinguishing partnerships from corporations for tax purposes. Indeed, if it were, the vast majority of the corporations in this country (whose shares are not publicly traded) would be treated as partnerships. It may be that the distinction between corporations and partnerships should be reconsidered, as it has been through the years. However, the factor of tradeability of interests alone should not determine whether an entity is treated as a partnership or a corporation. As Mr. Pearlman stated in his opposition to the proposal:

> "The proper classification and methodology for taxing publicly held limited partnerships are difficult questions which we think should be answered only after a thorough review of the taxation of all similar business organizations, including real estate investment trusts. We have serious doubt that after such an analysis one would conclude that the degree of marketability of an organization's equity interests should determine the manner in which the organization is taxed. We also are not convinced that access to a rational system of pass-through taxation should be restricted on the basis suggested by the classification proposal."

The Staff has reacted to an exaggerated article in Forbes magazine entitled "Disincorporating America." The Staff's proposal indicates that publicly traded partnerships represent a widespread tax avoidance technique. In reality, only a dozen or so publicly traded partnerships have ever been formed, and even the Treasury Department has concluded that "the concern over a migration of corporations into partnership form is overstated." Furthermore, an examination of the transactions which have been undertaken to date demonstrate that they have significance and motivation independent of tax considerations. The proposal should be rejected as an unwarranted and unreasoned interference with commerce and with taxpayers' choice of business form.

Hart H. Spiegel

EATING HABITS

Date:

Time of Day	Duration of Eating Episode	Eating Location	Type and Amount of Food	Behavioral Project

Date:

Time of Day	Duration of Eating Episode	Eating Location	Type and Amount of Food	Behavioral Project

Date:

Time of Day	Duration of Eating Episode	Eating Location	Type and Amount of Food	Behavioral Project

PETROLEUM INVESTMENTS, LTD.
SUITE 1410 - 50 PENN PLACE
OKLAHOMA CITY, OKLAHOMA 73118

TELEPHONE
BUS 405/840-3293
RES 405/843-4717

October 17, 1983

Mr. Roderick De Arment
Chief Counsel
Senate Finance Committee
Dirksen Senate Building
Room SD 219
Washirgton DC 20510

Gentlemen:

The following is written testimony, on behalf of Petroleum Investments, Ltd., to be presented at the October 24, 1983, hearings regarding publicly traded limited partnerships:

PETROLEUM INVESTMENTS, LTD.

POSITION STATEMENT - PUBLICLY TRADED PARTNERSHIPS

It is the opinion of Petroleum Investments, Ltd. that the underlying reason for the recent staff proposal regarding publicly traded partnerships is the Treasury's concern over the possible revenue loss that might arise if, in fact, the use of publicly traded partnerships leads to the "disincorporation" of America.

Petroleum Investments, Ltd. is not prepared to support a position that allows for "disincorporation" and subsequent formation of publicly traded partnerships where the specific intent and purpose is to avoid certain applicable corporate tax provisions. Petroleum Investments, Ltd. supports and agrees with the position that publicly traded partnerships, created for the specific purpose of achieving liquidity for their limited partner investors, should be permitted. The rationale for this position lies in the belief that the financial privilege for, and the desirability of, liquidity is no less important for a limited partner in a partnership than for an investor or shareholder in a corporation.

In regard to the special tax treatment for limited partnerships and their ability to distribute tax sheltered revenues to their unitholders, those partnerhip revenues would be substantially tax sheltered whether publicly traded or not. Therefore, the "publicly traded" characteristic, ipso facto, in no way results in loss of revenues to the Treasury.

In addition, when depositary units are sold, the sale results in substantial IDC recapture which would actually amount to a revenue gain to the Treasury.

Mr. Roderick De Arment
Chief Counsel, Senate Finance Committee
October 17, 1983
Page Two

Petroleum Investments, Ltd. supports the right of limited partnerships to achieve liquidity through public trading. We reiterate our firm belief that a clear demarcation exists between the procedure of "disincorporating" an existing corporation and that of transforming an existing limited partnership from a non-publicly traded entity into one with free-transferability characteristics. This distinction is paramount, and should form the basis for our legislative efforts. Thank you.

Sincerely,

PETROLEUM INVESTMENTS, LTD.

Brian F. Egolf

Brian F. Egolf

BFE:pc

SHARE THE WORK COALITION

We represent the fifty million unemployed persons of the Free World.

Wallace D. Barlow
Executive Director

6210 Massachusetts Ave.
Bethesda, MD 20816

Tel: (301) 229-6066
Cables: Intresecon

PREPARED STATEMENT FOR THE SENATE COMMITTEE ON FINANCE

Date of Hearing: October 24th, 1983

Subject: Reform of Corporate Taxation

In 1980, the corporation tax rate was 48%. The rates actually paid were:

For the capital intensive industries: 19%
For the labor intensive industries: 33%

This difference is largely due to the granting of liberal tax credits. This has been going on for sixty-five years. Since the "smoke stack" industries employ as much as five times as many persons as the automated industries, the result has been an intolerable increase in unemployment, hunger and moral decay.

We conclude that the following course of action is indicated:

Phase One: MEASURE the labor content of all U.S. industries.

Phase Two: MODIFY the corporation tax rates so as to slow the rate of automation.

Phase One has been completed. The Coalition has published a book entitled "Labor Content of U.S. Industries". Up-dated editions will be forthcoming. In our book, Labor Content is defined as "Wages as a percentage of Value Added." In the United States, we find that the labor content has fallen from 46% in 1870 to 30% in 1982. The range is from 10% to 60%.

The term, "Wages", is broadly defined. Included in the term are:

Wages and fringe benefits
Salaries of clerical and professional workers
Salaries of "middle management"

Excluded from the term "Wages" are:

Proprietary incomes

Salaries of top management, (Officers and Directors)

Top management fringes, including "golden parachutes"

Labor Content is computed for each industry with a Standard Industrial Classification code. Our source of information is the Census Bureau and other Commerce Department agencies. ("Human Effort Content" may be a better label, since professional workers and middle management persons are included.)

* * * * *

Phase Two will require legislation at the Federal, State and County levels. Pages 3 and 4 of this statement are a rough draft of a proposed House bill. The Senate bill would be identical. Seven congressmen are pledged to support this bill.

Legislation will also be required to adjust tariffs to provide more protection for the labor intensive industries; also, to insure that the proposed National Development Bank, if established, will use labor content as a guide in granting loans or in setting interest rates.

The Coalition is working with the United Nations to make this method of controlling unemployment available to all members.

The Coalition supports the Barlow Calendar. This new calendar would shorten the work year by 6%, thereby creating 8,000,000 new jobs.

Discriminatory taxation, as a method for achieving economic objectives, has been in use since 1538. It has always proven to be the least costly method.

We have applied for a U.S. patent on our plan to make the corporation tax rates inversely proportional to the labor content of the product. This plan will avoid the establishment of a caste system in the U.S., based on the present system of "welfare".

98th Congress
1st Session

H.R. _______

To amend the Internal Revenue Code of 1954 to impose a discriminatory tax on corporations.

IN THE HOUSE OF REPRESENTATIVES

Mr. ________, Mr. --------- and Mr. _________ introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

TO amend the Internal Revenue Code of 1954 to impose a discriminatory tax on corporations.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That Section 11b of part II of subchapter A of chapter 1 of the Internal Revenue Code of 1954 is amended by deleting "(b) Amount of tax. -- The amount of the tax imposed by subsection (a) shall be the sum of ----, and by inserting the following new section: (b) Amount of tax - The amount of tax imposed by subsection (a) shall be inversely proportional to the labor content of the average product of the corporation.

(c) Labor content is defined as wages, (broadly defined to include all salaries, except for those of top management and proprietors), as a percentage of value added.

H.R. ______ continued

(d) The Internal Revenue Service is directed to prepare tables, based on the present rates of tax, which will average out the same as the present rates of tax, but which will be inversely proportional to the average labor content of the products of the corporation.

(e) The Secretary of Commerce is directed to assist the Internal Revenue Service by up-dating these tables from year to year; also by determining the degree of discrimination to be imposed each year. The tilt will be changed from year to year to hold the unemployment rate down to three per cent of the work force.

* * * * * *

Footnote: Tables have been prepared from Census Bureau data which show the following tax rates for the following industries, if their taxable income exceeds $100,000:

Industry	Labor Content	Suggested Tax Rate
Agricultural Chemicals	19.6%	57%
Aircraft and Parts	50.6%	34%
Blast Furnaces	48.4%	35%
Utilities	14.7%	61%

Source: "Labor Content of U.S. Industries"
Published by Share the Work Coalition, 6210 Mass. Ave., Bethesda, MD

Sherman & Howard
A LAW PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

2900 FIRST OF DENVER PLAZA
633 SEVENTEENTH STREET
DENVER, COLORADO 80202

TELEPHONE 303 893-2900
TELECOPIER 303 893-2940
TELEX 454368

IN RENO, NEVADA
Hill Cassas deLipkau and Erwin, P.C.
POST OFFICE BOX 2790
RENO, NEVADA 89505
TELEPHONE 702 323-1601

SAMUEL S. SHERMAN, JR
WINSTON S. HOWARD
ROBERT M. JOHNSON
ARTHUR K. UNDERWOOD, JR
JOHN W. LOW
THOMAS B. FAXON
RAYMOND J. TURNER
GARTH C. GRISSOM
WILLIAM P. CANTWELL
MICHAEL D. GROSHEK
WILLIAM F. SCHOEBERLEIN
MICHAEL A. WILLIAMS
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DUNCAN A. CAMPBELL III
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DAVID THOMAS III
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ARLENE S. BOBROW
JULIAN K. QUATTLEBAUM III
ALAN J. GILBERT
HAROLD G. MORRIS, JR
RAYMOND M. DEENY
JEROME A. BREED
DEE P. WISOR
WALTER V. SIEBERT

RICHARD W. WRIGHT
Counsel

CHRISTINA C. BAUER
STANLEY M. RAINE
PETER B. NAGEL
GREG H. SCHLENDER
BARBARA FORT JONES
THEODORE A. OLSEN
CRAIG R. MAGINNESS
ELLEN W. REATH
SCOTT E. SPENCER
WILLIAM H. RUTTER
WILLIAM W. BOTHWELL
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MARY VOLK GREGORY
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*Also admitted in Colorado

October 21, 1983

Roderick A. DeArment, Esq.
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Sir:

As individual attorneys and members of the tax department of Sherman & Howard, we are writing from the perspective of a ninety year old law firm which has advised thousands of small businesses in the Colorado and Rocky Mountain region to express our views on a report prepared by the staff of the Senate Finance Committee entitled "The Reform and Simplification of the Income Taxation of Corporations" (the "Study"). We request that this letter be included in the Record of Proceedings of the Hearings conducted with respect to the Study. In particular, we would like to comment on portions of the Study recommending the repeal of Sections 311, 336 and 337 of the Internal Revenue Code of 1954, as amended (the "Code"), thereby invalidating the holding in General Utilities and Operating Company v. Helvering, 296 U.S. 200 (1935). We sincerely believe strong policy and economic considerations warrant the retention of those sections in the Code and the preservation of the General Utilities doctrine.

In general, Section 311 enables a corporation to distribute property to its shareholders, either as a dividend in kind or, in certain limited cases, in redemption of stock, without recognition of gain or loss at the corporate level. Section 336 permits a corporation to liquidate and distribute all of its assets while avoiding recognition of gain at the corporate level. Section 337 permits corporations to sell their assets pursuant to a plan of liquidation without recognition of gain. The nonrecognition principle of both Sections 336 and 337 is subject to tax benefit recapture principles. On September 22, 1983, the Senate Finance Committee staff released the Study which, among other things, would repeal Sections 311, 336 and 337 and invalidate the General Utilities doctrine. As did the staff, we will refer to the "General Utilities doctrine" as a shorthand reference to the statutory policies which, in certain circumstances, permit corporations to dispose of their appreciated assets without the recognition of gain at the corporate level. For the following reasons, we urge that Sections 311, 336 and 337 and the General Utilities doctrine be retained in the present corporate income tax structure.

The General Utilities doctrine provides justifiable and necessary relief from double taxation of closely held corporations which encounter legitimate business reasons for the sale of their assets. The Study endorses the assumption that tax policy should be neutral in affecting investment decisions. Indeed, Section 351 attempts to permit the tax-free incorporation of a business so as to not discourage the operation of businesses in corporate solution. Sections 336 and 337 play an important role in the maintenance of that tax neutrality. In effect, a controlling shareholder makes a tax neutral decision to incorporate his business and, upon disposition of the business, under either a stock or asset sale, tax law also should be neutral and apply a single level of tax. In effect, the repeal of Sections 336 and 337 would destroy the tax neutrality of a taxpayer's decision whether to conduct his business through corporate form, a partnership or a sole proprietorship.

The adoption of the staff recommendations in this regard would lead to a substantial increase in the number of businesses operated through partnerships. The additional complexity of partnership operations would significantly increase the legal costs of owning and operating small businesses as well as increase the difficulty of audits by the Internal Revenue Service. The economic policy of the United States should not provide substantial incentives for the formation of partnerships. If we are correct in our belief that a substantial number of corporations would be converted into partnerships in response to the repeal of the General Utilities doctrine, little revenue would be raised by the recommendation.

The current national economic policy is to encourage the formation of small corporations. In this regard, studies have indicated that approximately 80 percent of the new jobs created in the United States are generated by businesses which employ 20 or fewer persons. Many bills are now pending in Congress to encourage the investment of funds in small businesses. While we do not endorse any specific capital formation incentive bill, their introduction is reflective of a national policy to encourage small business. The repeal of the General Utilities doctrine is inconsistent with that policy and would impose a substantial new burden upon the conduct of small business in the United States.

Since Section 337 liquidations are primarily utilized by small businesses, the burden of the repeal of the General Utilities doctrine would fall disproportionately upon small business. The economic vitality of small businesses mentioned above demonstrates the foolishness of that course of action. Furthermore, the owners of successful small businesses generally would utilize Section 337 transactions only once in their lives. We question whether once-in-a-lifetime transactions constitute the type of abuse which would properly trigger a repeal of the General Utilities doctrine. To the extent that the perceived problems are with large, publicly held corporations, such problems can be separately addressed.

If double taxation may be avoided at the shareholder level by the sale of stock to, or a tax-free reorganization with, a publicly traded corporation, the effect of the repeal of the General Utilities doctrine would provide a substantial incentive to centralize United States industry. Incentives to centralize fly in the face of the national policy of fostering the development of small business and are antithetical to the strong economic trend towards decentralization voiced by authors such as John Naisbett in his book, Megatrends. Clearly, adoption of such an economic policy would be unwise.

Finally, the repeal of Sections 311, 336 and 337 of the Code would be unfair to taxpayers who chose to operate their businesses in corporate form in reliance on the provisions of Sections 311, 336 and 337. If businessmen suspected the prospective repeal of those sections, many of them would have chosen to form partnerships instead.

Section 5.a.3(a) of the Study sets forth nine arguments supporting the repeal of the General Utilities doctrine. In the aggregate, those arguments are unpersuasive. We will comment upon each of the supporting arguments in turn.

(i) The first argument alleges that taxpayers often pay less tax under the current law than if no tax were paid at the corporate level. No examples of this phenomenon were reported. If the staff had the examples included in argument (vii) in mind, the tax benefits described therein depend not upon the *General Utilities* doctrine, but rather up on other tax policies unrelated to the issues of corporate level taxation. Disregarding the existence of graduated corporate income tax rates, we are unaware of any material instance in which the taxpayer pays less tax under current law than he would if corporate level taxation were repealed. Furthermore, if such a situation exists, the answer is not to repeal Sections 311, 336 and 337, but rather to address the particular abuses demonstrated.

(ii) While the *General Utilities* doctrine has contributed to the complexity of the Code, to suggest that the complex recapture rules of Section 1245 and 1250 as well as the Section 338 anti-selectivity rules are primarily a result of the *General Utilities* doctrine is an overstatement. Those provisions of the Code, while not perfect in scope or detail, have adequately addressed the abuse situations present under current law. The staff cited its fear of the development of new abuses as a reason for repeal. Legislation should not be passed by Congress on the basis of an unsubstantiated fear of potential, but as yet unidentified, abuse. The appropriate legislative response, when and if additional abuses are identified, is to address each such abuse directly rather than repealing a doctrine which has served the nation well for 50 years.

(iii) We agree that the provisions of Section 341 of the Code are both often ineffective and unfortunately complex. However, the problems inherent in the definition of a collapsible corporation do not provide an adequate basis for the repeal of provisions as economically important as Sections 336 and 337 of the Code.

(iv) We agree that uniformity of treatment of transactions under the Code is an appropriate measure for the effectiveness of tax legislation. Section 337, however, plays an important role in providing uniformity of treatment in stock and asset sales. When a shareholder completely terminates his investment in a business by reason of a stock sale or a Section 337 transaction, only one level of tax is appropriate.

(v) While we applaud a broadened tax base with lower income tax rates, the repeal of the *General Utilities* doctrine is not an appropriate means to that end. First, the anticipated revenue effects are overstated. The repeal of the General Utilities doctrine will result in a substantial increase in the operation of businesses through partnerships and accordingly, the new corporate level tax will be avoided. Second, if the corporate tax base is to be broadened, more appropriate targets for change can be found.

(vi) The concerns expressed in paragraph (vi) are addressed in the other proposals set forth by the staff and do not, by themselves, require a repeal of the General Utilities rule.

(vii) None of the examples stated in paragraph (vii) addresses the General Utilities doctrine; rather they constitute indirect attacks upon other policies embodied in the Internal Revenue Code. If Congress wishes to address the taxation of foreign investors, tax exempt entities or carry-over basis at death, then those issues should be addressed directly and not by way of a repeal of the General Utilities doctrine. Clearly, the correctness or incorrectness of these provisions is not a function of corporate level tax policies. Accordingly, none of the examples listed in paragraph (vii) provide a reason to repeal the General Utilities doctrine.

(viii) The thrust of the comments in paragraph (viii) is directed towards the ACRS system and not towards corporate level tax policy. As the committee noted, closely held corporations are subject to the anti-churning rules and if the real target of the comments is the creation of publicly traded partnerships, other proposals included in the Study adequately address that situation. Assuming that publicly traded partnerships will be taxable as corporations, their creation in a liquidation transaction will constitute an F reorganization and therefore, will not give rise to a stepped-up basis to support new ACRS deductions. Again, if reform of the ACRS system is intended, that reform should be undertaken directly and not accomplished indirectly through repeal of the General Utilities doctrine.

(ix) The Tax Court's decision in Telephone Answering Service v. Commissioner, 63 T.C. 423 (1974), provides an adequate basis for the Service to attack liquidation-reincorporation transactions. Where transactions are not undertaken pursuant to a plan, then, as has always been the case under general principles of federal income tax law, the transactions should be given independent tax significance. Accordingly, liquidation-reincorporation problems do not provide a basis for the repeal of the General Utilities doctrine.

For the above reasons, we urge the Senate Finance Committee to reject the staff recommendation that the General Utilities doctrine be repealed. Better and more appropriate ways to address the tax policy issues raised by the arguments embodied in paragraphs 5.a.3. (iii), (vi), (vii) and (viii) of the Study can be found. Repeal of the General Utilities doctrine would impose a substantial and unwarranted burden on small business.

Sincerely,

Sherman + Howard

The Tax Department of
SHERMAN & HOWARD

William P. Cantwell
Douglas M. Cain
Duane F. Wurzer
Constance L. Hauver
R. Michael Sanchez
David Thomas III
Cynthia C. Benson
Julian K. Quattlebaum, III
Jerome A. Breed
Greg H. Schlender
Peter B. Nagel
Barbara A. McDonnell
Susan B. Goddard
Peggy B. Knight
Ray J. Hernandez

LAW OFFICES
SIMPSON, FAIR & RINALDO
INCLUDING PROFESSIONAL CORPORATIONS
SUITE 1010
FIVE PALO ALTO SQUARE
PALO ALTO, CALIFORNIA 94306
(415) 424-9000

CABLE ADDRESS: CORPLAW
TELECOPIER: (415) 424-1403
TELEX: 704958

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FILE NO. ____________

SAN FRANCISCO
SUITE 3680
FOUR EMBARCADERO CENTER
SAN FRANCISCO, CALIFORNIA 94111
(415) 956-3175

October 14, 1983

Roderick A. DeArment, Esq.
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Hearings on Report on Reform of Corporate Taxation - Commencing October 24, 1983

Dear Mr. DeArment:

I hereby submit this letter for inclusion in the printed record of the above-referenced hearing. I am making this statement for submission becaues I am deeply concerned over some of the issues raised in the Finance Committee's staff report as it relates to so-called "loopholes" in the current tax laws.

The particular matter being considered by the Committee to which this statement relates is the 85% dividends-received deduction available to corporations. It is my understanding that the question has been raised as to whether such deduction constitutes a loophole or a present unintended benefit and whether the present holding period in Section 246(c)(1)(A) of the Internal Revenue Code of 15 days should be extended to some longer period.

My concern is not addressed to the question which has been raised of whether the full deductibility of short-term capital losses when coupled with the deduction creates a "loophole." I am concerned that an extension of the present 15-day holding period would cause more problems than are cured, and that more realistic means should be available to deal with the issue of short-term capital losses.

It is respectfully submitted that the present 85% dividends-received deduction for corporations is not a "loophole." The deduction is necessary to avoid complete double taxation to the corporate recipient of qualifying dividends since the issuer thereof has already paid income taxes on the earnings available for distribution as dividends. The 15% of dividends subject to tax on the corporate recipient still constitutes a form of double taxation. Furthermore, the corporate recipient's individual shareholders are again subject to taxation on the same dividend income to the extent such dividends become part of the earnings paid out as dividends by such corporate recipient.

While the issue has been raised earlier about "liberalizing" the corporate dividends-received deduction, for which significant positive evidence exists, to now consider a narrowing or contracting of this deduction through an extension of the holding period could have serious and far-reaching results.

The corporate dividend deduction has helped make equity investments appealing to corporate investors. Many corporate issuers, including banks, utilities and insurance companies, have important financial and even regulatory reasons to strengthen their balance sheets by issuing equity rather than debt securities.

Under the existing overall structure of our tax laws, any reduction in the incentive to corporate investors to buy equity securities may create severe hardships on many issuers who would be forced to compound the already staggering debt being issued to finance operations and expansion. Although most corporate investors as a general rule may hold equity securities for more than one year, the mere existence of a restriction that would cause them to lose the dividends-received deduction on dividends already earned if it had or wanted to dispose of the security within such year, would affect its initial decision on investing in the issuer's equity securities in the first place.

Recent studies have urged Congress and the Administration to find means to encourage and help the capital raising functions of corporations to finance the continued growth of our economy. The capital needs over the next 10 years are forecasted to be enormous. Any extension of the holding period for the corporate dividends-received deduction therefore could easily have severe repercussions on the ability of corporations to fund their capital needs by issuing permanent equity capital rather than debt.

Since corporate issuers pay dividends from after-tax earnings and the individual shareholders of the corporate recipients of such dividends also pay full tax (after a modest $100 exclusion) on dividend income, it is difficult to perceive the 85% dividends-received deduction as a "loophole." It would, in fact, appear that more revenues could be lost by the Treasury if this corporate deduction is restricted to any degree since the issuance of more debt securities instead of equity would only increase the tax deductions at the initial corporate level.

It is respectfully submitted that any consideration of modifying this deduction should be made only as part of a comprehensive study of the entire capital raising needs of our economy and the complete tax laws. Further ad hoc surgery on this important provision will not be in the best interests of anyone.

The Committee's consideration of this statement will be greated appreciated.

Very truly yours,

Murray L. Simpson

Murray L. Simpson

MLS/jml